Corporate Update

Significant 2015 Decisions Affecting Private Company M&A

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The following compilation is our second annual review of significant Delaware court decisions relating to private M&A transactions and disputes. All decisions were issued in 2015.

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A. Proxy Contests and Other Disputes Involving the Board

1. ***Elite Horse Investments Ltd. v. T3 Motion Inc.***, C.A. No. 10550-CB (Del. Ch. Jan. 23, 2015)

This decision serves as a reminder to companies engaging in equity financings that they should consider the risk of investors undertaking a hostile change of control. The decision also provides guidance on three statutory provisions of Delaware law, including that stockholder written consents that are not individually signed may be vulnerable to challenge.

This decision was a transcript ruling on a motion for a temporary restraining order brought by a stockholder (EHI) of T3 Motion Inc., an OTC Bulletin Board company (the Company). EHI sought to enjoin the board of directors of the Company (the Board) from taking certain actions and to maintain the status quo pending resolution of a declaratory judgment proceeding in which EHI sought a declaration that four individuals elected by EHI and seven other stockholders had been validly elected to the Board. The eight stockholders held about 65 percent of the outstanding shares of the Company, as a result of purchases they made in a financing transaction of the Company on December 1, 2014. On December 26, 2014, the stockholders delivered an executed written consent to elect the four individuals to fill vacancies on the Board. At that time, there were three directors in office—William Tsumpes (the CEO and Chairman), Steven Healy and Ki Nam—and the Company's bylaws provided for a seven-person Board.

On January 15, 2015, Tsumpes contacted Healy and Nam (but not the four new directors) to hold a board meeting. The tentative agenda included selling Company equity to a third-party investor, converting Company debt to equity and converting Tsumpes' unpaid salary to common stock. On January 16, 2015, EHI brought the declaratory judgment action. On January 15 and 16, 2015, the four new directors and Nam executed a unanimous board consent to remove Tsumpes as CEO and appoint a new CEO, effective upon Tsumpes' removal from the Board. The Board consent was delivered to the Company on January 20, 2015. Also on January 20, 2015, EHI and six other stockholders, holding approximately 58 percent of the Company's stock, delivered a signed written consent dated January 15, 2015 that ratified the earlier stockholder consent and removed Tsumpes and Healy from the Board. EHI then sought the TRO that was the subject of the transcript ruling.

In granting the TRO, the Court dispensed with three substantive issues raised by the Company. First, the Company argued that the first stockholder consent was unlawful because it was not a unanimous stockholder consent under Section 211(b) of the Delaware General corporation Law (DGCL). Section 211(b) provides in relevant part:

> "Unless directors are elected by written consent in lieu of an annual meeting as permitted by this subsection, an annual meeting of stockholders shall be held for the election of directors on a date and at a time designated by or in the manner provided in the bylaws. Stockholders may, unless the certificate of incorporation otherwise provides, act by written consent to elect directors; provided, however, that, if such consent is less than unanimous, such action by written consent may be in lieu of holding an annual meeting only if all of the directorships to which directors could be elected at an annual meeting held at the effective time of such action are vacant and are filled by such action."

Rejecting the Company's argument, the Court noted that Section 211(b) applies when a stockholder written consent electing directors purports to be in lieu of an annual meeting. However, the eight stockholders purported to elect directors by written consent in lieu of a special meeting. Moreover, no provision of the Company's charter or bylaws had been identified that would prohibit stockholders from filling vacancies by written consent.

Second, the Company argued that the first stockholder consent was invalid because the signatures of the consenting stockholders were not individually dated, in violation of DGCL §228(c). Section 228(c) provides that "[e]very written consent shall bear the date of signature of each stockholder or member who signs the consent. . . ." The Court noted that the date was on the first stockholder consent, and the signature page referenced execution being effective "as of the date first written above." The Court also noted that the 60-day period for delivery of consents to the Company under DGCL §228 had not lapsed. The Court then raised the question of what harm the requirement for dated signatures, from an equitable perspective, was designed to prevent. Nonetheless, the Court noted that the Company had raised a legitimate issue, although not one that needed to be resolved because the second stockholder consent appeared to be valid.

The third issue raised by the Company was that the first stockholder consent was invalid because "prompt notice" of it had not been given in compliance with DGCL §228(e). The Court noted that the first stockholder consent was delivered less than 30 days prior to the hearing, and the second one was delivered just three days prior to the hearing. The Court then rejected the Company's argument because the Company had not identified any authority interpreting the prompt notice requirement, and the Court could not conceive of any prejudice to the Company or any stockholders.

The ruling provides a cautionary tale for companies undertaking equity financings: consider the company's vulnerability to a hostile change of control and consider the need for incorporating standstill and other protections into the financing terms. The ruling also provides interpretive guidance with respect to DGCL Sections 211(b), 228(c) and 228(e). Perhaps the most useful guidance is that stockholder written consents that are not individually signed may be vulnerable to challenge.

» Read the ruling.

2. ***Partners Healthcare Solutions Holdings LP v. Universal American Corp.***, C.A. No. 9593-VCG (Del. Ch. June 17, 2015)

Decision provides that a Delaware corporation can impose reasonable restrictions on director designees, such as those relating to confidentiality or conflicts of interest, beyond the requirements expressly set forth in a board seat agreement.

As a result of a merger, pursuant to which an entity (Partners) sold a business to another company (UAM), Partners became a large stockholder of UAM and obtained the right to designate a director to the UAM Board. The sold business performed poorly after the merger, and litigation ensued between Partners and UAM. After Partners' initial designee resigned from the UAM Board, Partners sought to have a successor designee seated. UAM insisted that the successor designee sign a confidentiality agreement, and forego representation by the same law firms representing Partners in the litigation against UAM. The designee refused, and Partners brought an action in the Delaware Court of Chancery to enforce the board seat agreement by specific performance, and sought monetary damages.

The parties settled the specific performance action by agreeing that the law firm representing the designee in his individual capacity could construct an ethical wall and allow different lawyers at the firm to represent the designee and Partners, respectively. Partners continued the suit seeking damages and attorneys' fees. Vice Chancellor Glasscock granted summary judgment to UAM.

Under the board seat agreement, the director designated by Partners was required to be "independent" under stock exchange rules. Partners had a right to designate a successor director if its designee resigned. Further, the agreement provided information rights to certain funds affiliated with Partners, subject to confidentiality obligations and other restrictions not applicable to the designated board member.

The business performed poorly and UAM sent an indemnification demand to Partners. Eventually, settlement discussions broke down and UAM sued Partners, former officers of the business, and the director designated by Partners sitting on the UAM board, among others, alleging fraud. The designated director resigned and Partners designated a new director to fill the vacancy created. UAM presented the designee with a confidentiality agreement, pursuant to which he would be prohibited from sharing confidential information with any third party "other than counsel in connection with fulfilling [his] duties as a director. . . ." The agreement also specified that the director designee could not use the counsel representing UAM in the litigation. The specific performance claim was resolved after "substantial effort," by a confidentiality agreement and establishment of an ethical wall, a solution that "in hindsight, appears obvious."

In the damages action, Partners alleged that UAM breached the board seat agreement by requiring the second designee to sign a confidentiality agreement because the board seat agreement did not impose any conditions on the designee, other than that the designee be independent under the relevant stock exchange rules. Finding for UAM, the Court wrote: "I do not find that UAM breached the Board Seat Agreement. The Board, in a faithful discharge of its fiduciary duties, recognizes a conflict in the Designee engaging as counsel, in his capacity as a director and on behalf of UAM, the same counsel that was adverse to UAM in the Fraud Litigation." The Court also noted that it was important that "UAM did not outright refuse to seat [the designee], but instead agreed to seat him once the problem of conflicted representation was solved. That cannot be said to be a breach of the Board Seat Agreement."

The merger agreement provided a waiver by UAM of conflicts of interest in the law firm's representation of Partners and its affiliates in any dispute with UAM over matters relating to the merger agreement. (This type of waiver provision is quite common now in merger agreements involving private company targets.) Partners argued that this waiver extended to the conflict arising in the proposed representation by the law firm of the Partner designee as a UAM director. The Court disagreed, and held that the waiver was simply inapplicable to the designee's representation by counsel also representing Partners—that representation of the designee did not 'relate to' the merger agreement. In addition, the Court held that the designee was not an "affiliate" of Partners protected by the conflict waiver provisions. The Court noted that "[a]s a director, [the designee's] duties run to UAM and its stockholders, not to Partners.

The decision shows that a buyer may impose reasonable conditions relating to conflicts of interest or confidentiality of company information on a director, regardless of whether these issues are covered in a board seat agreement. The board's fiduciary duties require the board to impose these conditions to protect the company and its confidential information, and a court will uphold the board's exercise of its fiduciary duties. This case is helpful in confirming that not every conflict or issue regarding confidentiality has to be addressed in a board seat agreement.

» Read the decision.

» Read our article on conflict-of-interest waiver provisions.

» Read our article on representative directors.

3. ***Gorman v. Salamone***, C.A. No. 10183-VCN (Del. Ch. July 31, 2015)

Decision clarifies the respective rights of stockholders and the board of directors to govern the corporation by confirming the board's power to manage the corporation, that stockholders do not have the right to make substantive business decisions through stockholder-adopted bylaws, and that the removal of officers is a substantive business decision reserved to the board of directors.

The case arose when stockholder John Gorman, a stockholder and director of Westech Capital Corp.'s (Westech), attempted to amend the corporation's bylaws by written consent of stockholders. The bylaw amendment allowed stockholders to remove any officer of Westech by written consent with or without cause. Gorman then purported to remove the current CEO, Gary Salamone, and to elect himself into the role.

Gorman sought declarations from the Delaware Court of Chancery that Salamone was no longer an officer or director. He argued that DGCL Section 142(b), addressing officer selection, permitted the bylaw amendment. The Court held that Section 142(b) does not speak to how officers may be removed, nor does it expressly grant such a right to stockholders. The Court then considered Section 109 of the DGCL, which grants stockholders the authority to adopt and amend bylaws. The Court explained that "stockholders' ability to amend bylaws is not coextensive with the board's concurrent power," and is limited when it conflicts with the board of directors' power to manage the business and affairs of the corporation under Section 141(a) of the DGCL. Stockholders may not amend the bylaws of the corporation to make substantive business decisions, as their power under Section 109 is limited to defining "the process and procedures by which these decisions are made." The Court held that removing a corporate officer is indeed a substantive business decision that may only be made by the board. The proper way for stockholders to influence these management decisions is through their power to elect the board of directors.

» Read the decision.

» Read our earlier review of the case.

4. *Kerbawy v. McDonnell*, C.A. No. 10769-VCP (Del. Ch. August 18, 2015)

Decision provides that while written consents delivered by holders of a majority of a privately held company's stock can be set aside on equitable grounds, there is a high burden on the incumbent board challenging the consents and the equities will be weighed with a goal of supporting the will of the stockholders.

The plaintiff in this case was a stockholder, Kerbawy, who had solicited written consents for the purpose of replacing the current board of a privately held company with the plaintiff's nominees. The company had about 150 stockholders. The company was in the midst of a DOJ investigation of regulatory compliance, and that investigation, the company's strategy with respect to it and who was to blame for the situation was the crux of the consent solicitation, with the stockholder wanting a new approach to the DOJ investigation and new management.

Kerbawy emailed the consent forms to a group of stockholders he believed would be supportive of the solicitation, and by the end of the day he had obtained consents totaling 43 percent of the stock. He had support and some assistance from a current board member, DeFrancesco, who also held 24 percent of the stock, and a former officer, Bosley. These two had previously attempted to remove and replace the incumbent board when the board sought their resignation as employees during the pendency of the investigation. That prior solicitation failed, and Bosley had entered into a separation agreement with the company. DeFrancesco helped Kerbawy analyze the stockholder base and asked employees he knew to determine the level of support likely from employee stockholders. Bosley suggested candidates for the new slate. DeFrancesco sent Kerbawy confidential company information, including a stock ledger and a strategic planning document sent to the board.

The board found out about the Kerbawy solicitation the day it commenced, when a stockholder forwarded the email to the CEO. The board immediately took a defensive position seeking to defeat the effort. The board sent out a letter via email to all stockholders two days later, purporting to correct misinformation. The Court found that this letter gave a reasonable stockholder the impression that DeFrancesco was aligned with the board, and did not disclose that the board was excluding him from board meetings and treating him as an adversary. Five days after the solicitation launched, the plaintiff delivered written consents representing 53.3 percent of the outstanding shares.

The board had determined it was not going to accept the consents as valid and would not vacate seats until ordered to do so. Kerbawy commenced an action seeking a declaratory judgment that the new director nominees were validly elected. The incumbent directors filed a counterclaim to set aside the consents, arguing that the stockholder's disclosure in the solicitation was misleading, the consents used confidential information supplied by DeFrancesco in breach of his fiduciary duties and the plaintiff had tortiously interfered with the separation agreement with Bosley.

The Court noted that the "burden of proving that a director's removal or election is invalid rests on the person challenging the invalidity" and that "where a majority of stockholders have executed written consents removing the Board, and the Board asks the court to set aside the consents on equitable grounds, that burden is a heavy one." The board argued that the plaintiff, a minority stockholder, had fiduciary duties because he was being assisted by a director. Directors owe a duty of disclosure (or candor), the "duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action." The Court rejected the notion that a minority stockholder has this duty. A stockholder might have an action against another stockholder soliciting written consents for fraud, but no stockholder alleged that he or she was defrauded by the plaintiff.

DeFrancesco, the director working with the plaintiff stockholder, allowed the plaintiff to use documents and information obtained as a result of his current role as director and prior role as CEO of the company, and he allowed the plaintiff to use the director's name and a quote from him in support of the solicitation. Thus, that director would have had a duty of disclosure, but the Court found that all the challenged disclosures were those of the plaintiff stockholder, not the director assisting that stockholder. The Court was reluctant to impute the fiduciary duties of the director to the stockholder he was assisting. However, the Court didn't reach this question definitively, because the Court concluded that the disclosure violations alleged were in any case insufficient to justify setting aside the consents solicited.

Defendants alleged that the misleading statements underplayed the role of the director DeFrancesco and also Bosley. The Court concluded that the roles of DeFrancesco and Bosley were not mischaracterized by Kerbawy, and even if they had been, the defendant board had made equally misleading statements about the role of the two participants in question. DeFrancesco had been frozen out of board meetings discussing the solicitation and all board communications on the matter. The board implied in its communication to stockholders that DeFrancesco remained on the board and therefore was "vehemently" opposed to the solicitation. Given the misleading statements going both directions by the plaintiff and the defendants, the Court did not believe it was equitable to set aside the consents on the grounds that the plaintiff did not disclose something that the board itself failed to disclose "when it had the time and ability to do so."

The Court also concluded that Bosley had breached his separation agreement with the company, which contained a standstill preventing the former employee from directly or indirectly soliciting consents or becoming a "participant" in or assisting any other person in a solicitation, or misusing company confidential information. Bosley had provided some minor assistance to the stockholder, but he was not a party to the action, and the board had to prove that the stockholder Kerbawy had tortiously interfered with the agreement. Further, the shares voted by the employee were insufficient to reduce the total affirmative consents below a majority. Even if the tortious interference was proven, the Court concluded that it would have to weigh the harm of not invalidating a consent solicitation advanced in part by that employee's breach of his separation agreement against the harm of frustrating stockholder intent seeking to replace the board. Here if the employee had not helped the stockholder, the solicitation would still have succeeded, but if the consents were set aside the incumbent board would remain in control. The Court concluded that enforcing the contract would not further a valid corporate or stockholder interest, but rather would benefit primarily, if not solely, the incumbent board.

Finally, the Court confirmed that stockholders can act by written consent without notice, unless notice is prescribed by the company's bylaws or certificate of incorporation, not the case here.

This case clarifies that incumbent boards cannot thwart stockholder consent solicitations without establishing sufficient equitable grounds, which is a heavy burden. Where a company actively solicits against a stockholder, the merits of its disclosure will be weighed against any allegations of misleading statements by the stockholder. The Delaware courts will not take sides on the merits of a solicitation, leaving the decision as to who would be the best directors to the stockholders themselves. Delaware courts will seek to uphold the will of the stockholders in support of the stockholder franchise in the absence of "a breach of fiduciary duty, breach of contract, fraud or other wrongdoing that so 'inequitably tainted the election" that the court must intervene. The Court found no reason to do so in this case.

» Read the decision.

B. Fraud Claims in M&A Transactions

5. ***Aviation West Charters LLC v. Jeremy Freer***, C.A. No. N14C-09-271 WCC CCLD (Del. Super. Ct. July 2, 2015)

Court rules that (i) integration clause does not preclude fraudulent inducement claim based on materially false financial statements where the integration clause does not contain an express disclaimer of reliance, and (ii) founder, President and CEO could be liable for fraudulent inducement, even though he did not make representations under the purchase agreement, where plaintiff alleged he made oral and written representations and concocted the fraudulent scheme.

This decision involved a motion to dismiss in a dispute stemming from the sale of an air ambulance business (the Company). Prior to its sale, the Company was operated by another company (JTF), of which defendant Freer (together with JTF, the JTF Defendants) was the founder, owner and president. The Company's business model was to charge a $14,000 retainer and seek the remaining fees, which averaged $380,000 per flight, from the patient's insurer. Collections from insurers varied significantly.

The Company's financial statements were prepared on a modified cash (as opposed to accrual) basis and were typically reviewed but not audited. In connection with its sale, the Company prepared accrual financials intended to comply with GAAP for its 2013 fiscal year, and retained an independent accountant, CliftonLarsonAllen LLP (CLA) to audit them. CLA proposed adjustments, principally to the valuation of net accounts receivable, which resulted in an increase in net income of approximately $30 million, and which the Company accepted prior to CLA issuing a clean audit opinion. The 2013 audited financials showed 2013 EBITDA of $40.8 million and net accounts receivable (A/R) as of December 31, 2013 of $38.4 million. In June 2014, following a marketed sale process, the Company was sold to a private equity acquiror pursuant to an asset purchase agreement (the APA) for $80 million. The acquiror (the Plaintiff) subsequently brought claims against the JTF Defendants and another party for fraudulent inducement, and breach of contract, warranty and implied covenant of good faith and fair dealing, among others, based on allegations that the Company intentionally overstated its accounts receivable and revenue by approximately $30 million.

In considering the motion to dismiss the fraudulent inducement claim, the Court noted that in order to survive the motion, a plaintiff must allege that "(1) defendant falsely represented a material fact or omitted facts that the defendant had a duty to disclose; (2) defendant knew the representation was false or made with a reckless indifference to the truth; (3) defendant intended to induce the plaintiff to act or refrain from action; (4) plaintiff acted in justifiable reliance on the representation; and (5) plaintiff was injured by its reliance on defendant's representation."

With regard to the first element, Freer claimed that he could not be personally liable because he did not personally make any contractual representations. Rejecting this argument, the Court noted that "it is well-settled law that officers and directors may be liable for tortious misconduct even though they were acting on behalf of the business." The court found that Freer "not only made numerous oral and written representations to Plaintiff about [the Company], Plaintiff also alleges that Freer 'concocted' the fraudulent scheme. . . . Because of Freer's role as a President and CEO, and his involvement in the negotiation and sale of [the Company] to Plaintiff, Plaintiff has sufficiently alleged a claim against him for fraudulent inducement."

The JTF Defendants also argued that Plaintiff's fraud claims were impermissibly bootstrapped to its breach of contract claims, citing to authority that "where an action is based entirely on a breach of the terms of a contract . . . and not on a violation of an independent duty imposed by law, a plaintiff must sue in contract and not in tort." The Court rejected this argument, which equates to nonrecognition of claims for fraudulent breach, because it does not apply with respect to claims for fraudulent inducement.

With regard to the second element, the JTF Defendants contended that the fraud claim related to a calculation of a GAAP-compliance estimate of A/R and not a misstatement of fact. Rejecting this argument, the Court noted that the allegations related to improper inflation of A/R and 2013 EBITDA, which involved a statement of past fact and not of opinion or future conduct. The Court also found that the third element was satisfied because Plaintiff alleged that Freer "knowingly concealed" the Company's true financial condition, "knew all along" that Medicare Flights were unprofitable, "knew" that the 28 percent collections rate was an overstatement, and "knew" that the EBITDA representation "was false" and the 2013 financials were "knowingly, intentionally, and purposefully false."

With regard to the justifiable reliance element, Freer contended that Section 12.2 of the APA precluded Plaintiff from relying on any representation made prior to entering into the APA. Section 12.2 set forth an integration clause, which provided in relevant part:

> "The Disclosure Schedule, the Schedules and the Exhibits referenced in this Agreement are incorporated into this Agreement and collectively with the Confidentiality Agreement and this Agreement contain the entire

> agreement between the parties hereto with respect to the transactions contemplated hereunder, and supersede all negotiations, representations, warranties, commitments, offers, contracts and writings prior to the date hereof, including the letter of intent dated, February 7, 2014, between the Vistria Group, LP and Seller."

The Court noted that Delaware courts have "held that integration clauses will not be given effect to bar allegations of fraudulent inducement based on extra-contractual statements made before the effectuation of the contract unless such clauses contain an explicit anti-reliance representation." The Court found that Section 12.2 did not contain an explicit disclaimer of reliance, and thus did not bar Plaintiff's fraudulent inducement claim.

The Court dismissed the breach of contract and warranty claims against Freer because the representations and warranties were only made by the "Seller," which was JTF, and not by Freer. In denying the motion to dismiss the claim for breach of implied covenant of good faith and fair dealing, the Court noted that Plaintiff's implied covenant contained in the financial statements representation "is that JTF would not artificially inflate any of the A/R in the Financial Statements that would induce Plaintiff to pay a higher price than it otherwise would if it knew the truth of the financial condition of AMF."

This decision provides a useful drafting tip with respect to integration clauses. In order to be able to rely on these clauses to dismiss fraudulent inducement claims, sellers should ensure that the clauses contain express disclaimers of reliance. The decision also provides a reminder to officers and directors that they can be held personally liable for fraudulent inducement, even though they may be acting on behalf of the company being sold. (The same Judge provided similar guidance in another decision later in the year, *TrueBlue Inc. v. Leeds Equity Partners IV LP, 2015 Del. Super. LEXIS 524 (Del. Super. Ct. Sept. 25, 2015)*)

» Read the Aviation decision.

» Read the TrueBlue decision.

6. ***Prairie Capital III LP v. Double E Holding Corp.***, C.A. No. 10127-VCL (Del. Ch. November 24, 2015)

Court gave expansive interpretation to "exclusive representations" language to preclude fraud claims based on alleged representations and omissions outside the share purchase agreement, and eschewed need for "magic words" as reliance disclaimer.

This case arose from the sale of Double E Parent LLC, a portfolio company of private equity firm Prairie Capital Partners (Prairie Capital), to an affiliate of another private equity firm, Incline Equity Partners (together with the affiliate, referred to as Incline).

In early 2012, while the sales process was ongoing, the company's CEO and CFO recognized that the company was not going to meet the March sales target provided to Incline, and fabricated roughly $650,000 of sales in March to make it appear that the company had met its target.

Incline decided to buy the company after receiving the fabricated information. The parties executed a stock purchase agreement (the SPA) and closed the same day. Among the SPA's representations and warranties were those for absence of changes, accounts receivable, financial statements and undisclosed liabilities, and compliance with laws. There was an escrow fund established to fund indemnification obligations from breach of representations and warranties. The SPA contained an "exclusive representations" provision that stated:

> "The Buyer acknowledges that it has conducted to its satisfaction an independent investigation of the financial condition, operations, assets, liabilities and properties of the Double E Companies. In making its determination to proceed with the Transaction, the Buyer has relied on (a) the results of its own independent investigation and (b) the representations and warranties of the Double E Parties expressly and specifically set forth in this Agreement, including the Schedules. SUCH REPRESENTATIONS AND WARRANTIES OF THE DOUBLE E PARTIES CONSTITUTE THE SOLE AND EXCLUSIVE REPRESENTATIONS AND WARRANTIES OF THE DOUBLE E PARTIES TO THE BUYER IN

> CONNECTION WITH THE TRANSACTION, AND THE BUYER UNDERSTANDS, ACKNOWLEDGES AND AGREES THAT ALL OTHER REPRESENTATIONS AND WARRANTIES OF ANY KIND OR NATURE EXPRESS OR IMPLIED (INCLUDING BUT NOT LIMITED TO, ANY RELATING TO THE FUTURE OR HISTORICAL FINANCIAL CONDITION, RESULTS OF OPERATIONS, ASSETS OR LIABILITIES OR PROSPECTS OF DOUBLE E AND THE SUBISIDIARIES) ARE SPECIFICALLY DISCLAIMED BY THE DOUBLE E PARTIES."

The exclusive representations clause was backed up by a standard integration clause, which provided that the SPA "set[s] forth the entire understanding of the Parties with respect to the Transaction, supersede[s] all prior discussion, understandings, agreements and representations. . . ."

Two days before the escrow release date, Incline submitted a claim notice which indicated that Incline believed the company had engaged in fraud. The sellers' representative filed suit to compel the release of the escrow and Incline counterclaimed, asserting in part a claim for fraud by the company and its CEO and CFO, based both on the SPA representations and on extra-contractual statements and omissions during the sale process and due diligence.

The Court granted in part and dismissed in part Incline's motion to dismiss. The Court found that Incline had waived the right to bring a claim of fraud regarding the extra-contractual representations and omissions, but that Incline had shown it was reasonably conceivable that the CEO, CFO and selling stockholders could be held liable for the fraudulent contractual representations. The Court also found Incline had sufficiently plead the claim of breach of several representations in the SPA.

The Court held that Incline's claims based on extra-contractual representations were foreclosed by the exclusive representations and integration language in the SPA. The Court noted that Delaware law enforces clauses that identify the specific information on which a party has relied and which forecloses reliance on other information, citing *RAA Mgmt, LLC. v. Savage Sports Hldgs Inc.*, 45 A.3d 107, 118-119 (Del. 2012). Incline argued that the language in the SPA, quoted above, was not a clear anti-reliance clause, relying on *Anvil Holding Cor. v. Iron Acquisition Company*, 2013 WL 2249655 (Del. Ch. May 17, 2013). The Court acknowledged that disclaimer clauses are often stated negatively (i.e., buyer is not relying on any statements not included in the agreement), while the clause in the SPA was framed positively (buyer is only relying on the representations included in the agreement). The Court concluded, however, that it was irrelevant whether the disclaimer was framed positively or negatively, so long as it clearly defined the universe of information Incline had relied upon, and in so doing excluded any other information on which Incline could state a claim. The Court would not read *Anvil* to require "magic words" such as "disclaim reliance."

As a second argument, Incline attempted to avoid the exclusive representations language by claiming that it did not apply in the case of fraudulent omissions. In *TransDigm Inc. v. Alcoa Global Fasteners Inc.*, 2013 WL 2326881 (Del. Ch. May 29, 2013), Vice Chancellor Parsons had held that an adequate disclaimer of reliance does not bar claims of fraudulent concealment if the buyer has not disclaimed reliance on extra-contractual omissions; rather, the buyer must also disclaim reliance on "the accuracy and completeness" of the information provided to it by the seller. The Court rejected this reasoning, stating that "to the extent *TransDigm* suggests that an agreement must use a magic word like 'omissions,' then I respectfully disagree with that interpretation." Vice Chancellor Laster noted that every misrepresentation involves to some extent an omission of the truth, and held that the SPA's exclusive representations and integration language, which defined the universe of information Incline was relying on, was sufficient to exclude a fraud claim based on an extra-contractual omission.

It is worth noting that in *Prairie Capital*, Incline had simply recast its claims of affirmative misstatements as claims of omissions, with the same underlying facts giving rise to both the misstatements and the omissions. In contrast, in *TransDigm* the buyer had alleged that the seller had concealed the fact that it had offered a major customer a discount and was at risk of losing about half of that customer's business. The Court there had held that the buyer could rely on the assumption that the seller had not actively concealed information or engaged in a scheme to hide that material information. Thus it is possible that a claim of concealment of information could survive an exclusive representations provision, so long as it is not simply a mirror image of the claims of reliance on misstatements. However, the two decisions cannot be wholly reconciled and it may be that the issue of when omissions are disclaimed will require the input of the Delaware Supreme Court.

As a third argument, Incline attempted to avoid the exclusive representations language by arguing that a separate "exclusive remedy" clause was evidence that Incline had a right to sue for extra-contractual fraud. The "exclusive remedy" clause provided that "[e]xcept as provided in [specified sections], equitable remedies that may be available, or in the case of fraud, the remedies set forth in this Article X [relating to indemnification] constitute the sole and exclusive remedies for recovery of Losses incurred after the Closing arising out of or relating to this Agreement and the Transaction." Incline argued that because the provision stated that contractual indemnification is not the sole and exclusive remedy in the case of fraud, Incline had a right to bring fraud claims. The Court instead found that the exclusive remedy provision only provided that in cases of fraud, Incline was not limited to the contractual indemnification provisions, but had other available remedies. The Court noted that the exclusive remedy provision did not address the representations that Incline may rely upon to establish a fraud claim, which were expressly addressed in the exclusive representations provision. Thus, the exclusive remedy provision did not reinstate a claim Incline had disclaimed elsewhere in the agreement.

The Court also held that Incline had adequately plead claims based on the absence of changes and accounts receivable representations and on the financial statements and undisclosed liabilities representation but only for the periods of time specified in the representations. The director and officer defendants sought to dismiss claims against them individually, but the Court held that neither officers nor directors could escape liability if they actively participated in the fraud, even if acting "for the corporation." The officers of the company were communicating with Incline, and the directors were communicating to the officers with the intent that their statements would be repeated to Incline, oversaw the process, actively engaged in the preparation of presentation materials and approved the creation of false sales numbers. Thus the claims against the individual defendants were not dismissed.

The decision gives buyers and sellers useful drafting guidance in how to limit (or avoid limiting) recourse for fraud claims based on extra-contractual representations.

» Read the decision.

C. Deal Mechanics

7. ***Halpin v. Riverstone National Inc.***, C.A. No. 9796-VCG (Del. Ch. Feb. 26, 2015)

This decision highlights the importance of exercising drag-along rights strictly in accordance with their terms if parties want to obtain the intended benefits, such as waiver of appraisal rights.

This decision involved competing motions for summary judgment in an appraisal action and counterclaim following the sale of Riverstone National Inc. (the Company) pursuant to a merger agreement. The Company's counterclaim was for specific performance by the appraisal petitioners (the Minority Stockholders) for compliance with the drag-along provisions of a stockholders agreement and waiver of their appraisal rights.

The minority stockholders entered into the stockholders agreement with the Company in June 2009. Section 3 of the stockholders agreement set forth a drag-along provision, pursuant to which the Company could compel the Minority Stockholders to tender and/or vote their shares in favor of a change-in-control transaction approved by the majority stockholders. Section 3 provided the following in relevant part (the Voting Right):

> "[I]f at any time the Company and/or any Transferring Stockholders propose to enter into any such Change-in-Control transaction, the Company may require the Minority Stockholders to vote in favor of such transaction, where approval of the shareholders is required by law or otherwise sought, by giving the Minority Stockholders notice thereof within the time prescribed by law and the Company's Certificate of Incorporation and By-Laws for giving notice of a meeting of shareholders called for the purpose of approving such transaction."

On May 29, 2014, the Company's controlling stockholder provided its written consent for the Company to enter into a merger agreement pursuant to which the Company would be sold in a reverse triangular merger. The Company executed the merger agreement the next day and completed the merger on June 2, 2014. On June 9, 2014, the Company sent an information statement to its stockholders informing them of the merger, and attempting to invoke the drag-along provisions and compel compliance with the Voting Right. The information statement provided that stockholders may be entitled to appraisal rights, but they would only be entitled to the merger consideration if they relinquished the appraisal rights by executing an attached written consent. It also provided that if the stockholders failed to execute the written consent, they would be in breach of the stockholders agreement.

The Court first noted that it was a matter of first impression as to whether a common stockholder could waive its statutory appraisal right ex ante. However, the Court did not need to resolve that issue because the summary judgment decision would be resolved on other grounds. The Court noted that the information statement attempted to invoke the Voting Right, and that this involved a prospective obligation: the stockholders agreed to vote in favor of a prospective transaction, not consent to a merger that had already been consummated. Therefore, the Company was not entitled to specific performance of the drag-along because the drag-along involved a right that was different from the one the Company was trying to exercise. The Court also rejected the Company's claim for specific performance based on the implied covenant of good faith and fair dealing, because that doctrine does not apply with respect to rights that were not contracted but which were foreseeable.

The decision provides useful guidance regarding the exercise of drag-along rights and the need to strictly comply with their terms. It also cautions that while holders of preferred stock can be required to sign prospective waivers of appraisal rights, Delaware courts have not ruled on the enforceability of such waivers as applied to common stock.

» Read the decision.

» Read our earlier review of the opinion.

8. *Lazard Technology Partners LLC v. Qinetiq North America Operations LLC*, 114 A.3d 193 (Del. Apr. 23, 2015)

Court rules that earnout language prohibiting buyer from taking any action to "divert or defer [revenue] with the intent of reducing or limiting the Earn-Out Payment" bars buyer from taking action "specifically motivated by a desire to avoid the earn-out" but not action that buyer merely "knew would have the effect of compromising seller's ability to receive the earn-out."

This decision involved an appeal on behalf of former stockholders (collectively, the seller) of a target company in an earnout dispute arising under a merger agreement. The appellee (the buyer) paid $40 million at closing and agreed to pay up to an additional $40 million under a revenue based earnout provision. When the revenue targets were not achieved, the seller brought an action in the Delaware Court of Chancery for breach of Section 5.4 of the merger agreement, which prohibited the buyer from "tak[ing] any action to divert or defer [revenue] with the intent of reducing or limiting the Earn-Out Payment," and for violation of an implied covenant of good faith and fair dealing. In a post-trial bench ruling, the Court of Chancery found that Section 5.4 was not breached because the seller had not proven that any business decision of the buyer was motivated by a desire to avoid an earn-out payment. The Court of Chancery also rejected the implied covenant claim because, consistent with the language in Section 5.4, the buyer had a duty to refrain from conduct only if it was taken with the intent to reduce or avoid an earn-out altogether.

On appeal, the seller argued that Section 5.4 prohibited conduct that the buyer "knew would have the effect of compromising the seller's ability to receive an earn-out." In upholding the Chancery Court's ruling, the Delaware Supreme Court ruled that by its unambiguous terms, Section 5.4 "only limited the buyer from taking action intended to reduce or limit an earn-out payment. Intent is a well-understood concept that the Court of Chancery properly applied. The Seller seeks to avoid its own contractual bargain by claiming that Section 5.4 used a knowledge standard, preventing the buyer from taking actions simply because it knew those actions would reduce the likelihood that an earn-out would be due." The Delaware Supreme Court also noted that the Court of Chancery "never said that avoiding the earn-out had to [be] the buyer's sole intent, but properly held that the buyer's action had to be motivated at least in part by that intention."

The Delaware Supreme Court also rejected the seller's argument that the Court of Chancery erred by holding that the implied covenant had to be read consistently with Section 5.4. In upholding the Court of Chancery's ruling that the implied covenant did not inhibit the buyer's conduct unless the buyer acted with the intent to deprive seller of an earnout payment, the Delaware Supreme Court noted that the implied covenant is a cautious doctrine that involves inferring contractual terms to handle developments or contractual gaps, and that the Court of Chancery was "very generous in assuming that the implied covenant of good faith and fair dealing operated at all . . . [given] the negotiating history that showed that the seller had sought objective standards for limiting the buyer's conduct but lost at the bargaining table."

The decision serves as a reminder that sellers need to clearly designate in the purchase agreement the standards to which buyers are to be held in earnout provisions. "Knowledge-based" prohibitions on buyer actions need to be specifically written into the contract and will not be implied from "intent-based" prohibitions.

» Read the decision.

D. Employee and Options Matters

9. ***Ascension Insurance Holdings LLC v. Underwood***, C.A. 9897-VCG (Del. Ch. Jan. 28, 2015)

Delaware choice of law for employee noncompete that was entered into several months after asset purchase agreement became effective was unenforceable given California public policy against enforcement of noncompetes against California residents employed and seeking to compete largely in California.

This decision addressed a request for preliminary injunction against the defendant and his current employer from breaching a covenant not to compete entered into by the defendant as part of an employee investment agreement (EIA) that was executed several months after an asset purchase agreement (the APA). The APA and a contemporaneous employment agreement contained five-year noncompetes. The noncompete in the subsequent EIA extended for a period of two years after defendant's termination of employment. The EIA was between a California resident employee and a Delaware limited liability company (the LLC) that had its principal place of business in California, and contained Delaware venue and choice of law provisions.

The Delaware Court of Chancery first noted California's statutory prohibition of noncompetes under Cal. Bus. & Prof. Code §16600, which contains an exception relating to the protection of goodwill where the noncompete is part of a sale of equity (or assets). The Court then noted Delaware's policy favoring the right to freedom of contract, and that Delaware follows the Restatement (Second) of Conflict of Laws (the Restatement). According to the Court, the Restatement generally favors the parties' choice of law, except where, absent a choice-of-law provision, the contract would be governed by the law of a state which has a public policy under which a contractual provision would be void or limited. Given that the defendant was a California resident, the LLC had its principal place of business in California, and the EIA was negotiated in California and involved a noncompete that was limited almost completely to areas within California, the Court concluded that absent the choice-of-law provision, California law would apply.

The Court then considered whether enforcement of the covenant would conflict with a "fundamental policy" of California and, if so, whether California has a materially greater interest in the issue than Delaware. The Court first considered plaintiff's argument that the exception under the California statute relating to the sale of assets applied. The Court noted that while the EIA was contemplated at the time of the APA, the parties had not discussed including a noncompete in the EIA. The fact that the APA and a contemporaneous employment agreement signed by defendant contained five-year noncompetes indicated that the noncompete in the EIA could not have been relied on as part of the asset purchase. The court also rejected plaintiff's argument that the decision in *Fillpoint LLC v. Maas*, 146 Cal. Rptr. 3d 194

(Cal. Ct. App. 2012) showed that enforceability did not require that the EIA have been signed contemporaneously with the APA. The *Fillpoint* case involved the enforceability of a noncompete in an employment agreement that was signed one month after a stock purchase agreement. The stock purchase agreement contained a three-year noncompete, and the employment agreement contained a noncompete that extended for one year post-termination. The *Ascension* court noted that while the *Fillpoint* court read the stock purchase agreement and the employment agreement together, the *Fillpoint* court held that the noncompete in the employment agreement did not fall within the exception to the California noncompete statute. Noting that *Fillpoint* therefore did not support plaintiff's argument, the *Ascension* court found that the noncompete provisions of the EIA would violate a fundamental public policy of California. In balancing the interests of the two states, the court held that "California's specific interest is materially greater than Delaware's general interest in the sanctity of a contract that has no relationship to this state."

The decision serves as a reminder that noncompetes tied to, and that extend beyond, the term of employment are very unlikely to be enforceable in California, even if entered into around the time of the sale of a business. Moreover, parties should not assume that they can avoid California's public policy disfavoring noncompetes simply by contractually designating the law and venue of another state.

» Read the decision.

10. *Calma v. Templeton*, C.A. No. 9579-CB (Del. Ch. April 30, 2015)

Decision highlights the importance of designing option plans with director-specific limits and taking care in the selection of peer group members.

The case arose when a stockholder challenged a board decision to award restricted stock units (RSUs) to the nonemployee directors of Citrix Systems Inc. (Citrix). These grants were awarded to the nonemployee directors under a compensation plan that also covered employees, officers, consultants and advisers and it was approved by a majority of disinterested stockholders. The only compensation limits of the plan were that no beneficiary could receive more than one million RSUs per calendar year, which at the time could total as much as $55 million.

The Compensation Committee had approved grants to all nonemployee directors, including the members of that committee, and therefore the business judgment rule did not apply. Stockholder ratification is an affirmative defense to the alternate standard of entire fairness, and leads to waste being the standard of review. However, the court ruled that the prior approval by stockholders of the compensation plan did not constitute ratification of the board's later grant of RSUs to the nonemployee directors. The stockholders' approval was merely a generic approval of a compensation plan covering multiple and varied classes of beneficiaries and the stockholders were not asked to ratify any decision "bearing specifically on the magnitude of compensation to be paid to its nonemployee directors." Because stockholders had not been asked to ratify the specific RSUs granted to the nonemployee directors, or to approve any sub-limit in the plan relating to compensation payable to such directors, the court concluded the stockholders could not be said to have ratified the grants.

Absent stockholder ratification, the RSU grants were self-dealing transactions, subject to review under an entire fairness standard. Entire fairness requires a showing of fair price and fair dealing. With respect to fair price, the parties framed the issue as whether the grants were in line with a peer group of companies, and the court held that the plaintiff had raised "meaningful questions" as to the appropriateness of the composition of the peer group employed by the board for this compensation decision, and therefore denied the motion to dismiss claims of breach of the duty of loyalty and unjust enrichment.

» Read the decision.

» Read our earlier review of the case.

11. ***Fox v. CDX Holdings Inc.***, C.A. No. 8031-VCL (Del. Ch. July 28, 2015)

The decision highlights the importance of following the valuation and other terms of stock option plans when cashing out options in a merger, including whether a portion of option proceeds can be withheld to fund a deal escrow.

This case involved a class action brought by an option holder who challenged the consideration option holders received for their options in a merger. The option holders held options in a privately held Delaware corporation, Caris Life Sciences Inc. (the Company). The Company operated three business units: Caris Diagnostics, TargetNow and Carisome. In order to realize a partial exit for stockholders and to generate funding for TargetNow and Carisome, the Company engaged in a spin/merger transaction that involved spinning off TargetNow and Carisome to its stockholders and having the resulting business (the AP Business) then enter into a cash merger with a subsidiary of a third party, Miraca Holdings Inc. (Miraca), for aggregate proceeds of $725 million. In connection with the merger, the option holders were cashed out based on a price of $5.07 per share, which represented $4.46 per share for the value of the AP Business acquired by Miraca in the merger, and $0.61 per share for the value of the two spun-off businesses. Approximately eight percent of the option proceeds were withheld and contributed to the deal escrow. The plaintiff brought a class action for damages based on breach of the terms of the Company's stock option plan (the Plan) in three ways: (1) failure by the Board of Directors of the Company (the Board) to determine the fair market value of a share of Company common stock and to adjust the options for the spin-off, (2) the valuation work performed was not done in good faith and was arbitrary and capricious, and (3) the option plan did not allow the Company to escrow a portion of the option consideration. Following a trial, the Court of Chancery found for plaintiff with respect to its claims based on breach of the Plan and awarded the class damages of $16,260,332.77. The plaintiff also advanced a claim for breach of the implied covenant of good faith and fair dealing, which the Court did not reach, given its decision on the breach-of-contract claim.

The Company was 70.4 percent owned by its founder, David Halbert, and 26.7 percent owned by a private equity fund, JH Whitney VI LP (Fund VI). The remaining 2.9 percent of the fully diluted equity of the Company was held by option holders. Under the terms of the Plan, option holders were entitled to receive in the merger an amount per share underlying their options equal to the excess of the "Fair Market Value" of each share of Company common stock over the option strike price. The Plan provided that the Fair Market Value was to be determined by the Plan Administrator, and that the Administrator was required to adjust the options to take account of the spin-off. The Board functioned as the Administrator.

The spin/merger structure was a way to achieve a tax efficient sale of the AP Business. However, it presented one large challenge. In order for the spin-off to be accomplished without triggering a corporate-level tax, the fair market value of the spun-off businesses could not exceed their respective tax bases. This was a sensitive issue in the negotiations with Miraca, and Miraca insisted that the spun-off businesses (owned by Halbert and Fund VI) retain responsibility for any such tax. Halbert therefore had a significant incentive to ensure that the fair market value of the spun-off businesses be low. This, in turn, would result in a low valuation for the options, because that value incorporated an upward adjustment based on the value of the spun-off businesses.

Evidence at trial showed that the valuation of the spun-off businesses, and the resulting value of the options, was determined by Gerard Martino, the Company's Executive Vice President and Chief Financial Officer, with sign-off from Halbert. Given that the fair market value of the options was not determined by the Board, as was required by the terms of the Plan, the Court found for plaintiff with respect to the first contention.

The valuation was based on an intercompany tax transfer analysis (as opposed to a fair market value analysis) prepared by the Company's tax advisor, using projections that Martino had manipulated downwards. At the insistence of Miraca, a second firm was retained to do an analysis. But the second firm understood its mandate as being to rubber stamp the first firm's analysis. The $65 million valuation of the spun-off entities was also significantly lower than recent estimates used for other purposes, such as that prepared by an investment bank in the sale process that resulted in the sale to Miraca, estimates derived from bidders' indications of interest in the sale process, internal estimates of the Fund VI, and 409A valuations. Accordingly, the Court found that the valuation work was not determined in good faith and was arbitrary and capricious.

With regard to plaintiff's third contention, the Court noted that unlike for shares, Section 251(b) of the Delaware General Corporation Law (DGCL) does not authorize the conversion of options in a merger. Options are instead rights governed by DGCL §157, and are governed by the terms of their contract, in this case the Plan. The Court noted that "the Plan gave the Board discretion as to whether to cancel the options in connection with the Merger, but if it did, then the option holders were entitled to receive 'the difference between the Fair Market Value and the exercise price for all shares of Common Stock subject to exercise.' The Plan did not permit an escrow holdback." As a result, the Company breached the terms of the Plan by withholding a portion of the option proceeds to fund the escrow.

The decision illustrates a failure of process by the Company and its Board when cashing out options in a merger. It is a reminder of the risks of failing to follow an option plan's terms, and of backing into a predetermined valuation as opposed to following a principled analysis. It also serves as a caution to drafters to ensure that option plans are drafted flexibly enough to accommodate escrows in sale transactions.

» Read the decision.

E. Ratification of Corporate Acts

12. ***In re Numoda S'holders Litig.***, C.A. No. 9163-VCN (Jan. 30, 2015), *aff'd*, 2015 WL 6437252 (Del. Oct. 22, 2015); ***In re CertiSign Holding***, C.A. No. 9989-VCN (Aug. 31, 2015)

Delaware courts provided important guidance as to the applicability and scope of Delaware's new statutory provisions regarding ratification and validation of corporate acts.

In 2014, two new provisions, Sections 204 and 205, were adopted to the Delaware General Corporation Law (DGCL). These provisions permit, among other things, boards to ratify, and the Court of Chancery to validate, prior corporate acts. The provisions were the subject of two Delaware court decisions in 2015.

Numoda was a post-trial decision of the Court of Chancery (later affirmed by the Delaware Supreme Court) that involved a dispute about the capital structures of two privately held corporations. The Court of Chancery in *Numoda* considered the validity of several acts that generally lacked the requisite corporate formalities, such as noticing board meetings, taking of minutes and issuing accurate stock certificates. As a preliminary matter, the Court considered the extent of the powers conferred under Sections 204 and 205. The Court noted that Section 205 allowed the Court to declare that a defective corporate act is effective as of the time of the act, and make such related orders as the Court deems proper under the circumstances. The Court noted that Section 205(d) provides that in deciding whether to exercise its authority, a court may consider:

> "(1) Whether the defective corporate act was originally approved or effectuated with the belief that the approval or effectuation was in compliance with the provisions of this title, the certificate of incorporation or bylaws of the corporation;
>
> (2) Whether the corporation and board of directors has treated the defective corporate act as a valid act or transaction and whether any person has acted in reliance on the public record that such defective corporate act was valid;
>
> (3) Whether any person will be or was harmed by the ratification or validation of the defective corporate act, excluding any harm that would have resulted if the defective corporate act had been valid when approved or effectuated;
>
> (4) Whether any person will be harmed by the failure to ratify or validate the defective corporate act; and
>
> (5) Any other factors or considerations the Court deems just and equitable."

The Court noted that the legislative synopsis for Section 204 indicates that Section 204 is intended as a safe harbor to fix void or voidable acts, and is intended to overturn the holdings in cases where, for example, many of the indicia of a valid stock issuance or stock split were present, but the courts refused to give effect to them because of the parties' failure to scrupulously follow the statutory requirements. The Court noted that the language of Section 205 did not give the Court clear guidance as to the scope of its remedial power, but the scope could not be unlimited. The Court noted that there must first be some underlying "corporate act", and observed:

> "the legislation's definition of 'defective corporate act' anticipated that a corporate act is an act within a corporation's power and 'purportedly taken by or on behalf of the corporation.' There does not appear to be a separate statutory definition of a 'corporate act,' . . . However, there must be a difference between corporate acts and informal intentions or discussions. Our law would fall into disarray if it recognized, for example, every conversational agreement of two of three directors as a corporate act. Corporate acts are driven by board meetings, at which directors make formal decisions. The Court looks to organizational documents, official minutes, duly adopted resolutions, and a stock ledger, for example, for evidence of corporate acts . . . The Court does not now draw a specific limiting bound on its powers under Section 205, but it looks for evidence of a bona fide effort bearing resemblance to a corporate act but for some defect that made it void or voidable."

The Court therefore employed a two-part test: first, there must be an identifiable corporate act, and then the Court must consider the five factors noted above in determining whether to validate the corporate act.

With regard to board approvals for some of the stock issuances in dispute, the Court noted that stock certificates had been issued (albeit with alleged defects), there were unsigned board minutes supporting an issuance, the board of directors had attempted to ratify the issuances, and the parties had acted as though the issuances were valid. The Court held that this was sufficient proof that the underlying board approvals constituted corporate acts. In determining whether to validate the corporate acts, the Court noted that the second, fourth and fifth factors listed above were the most important. The parties had operated for years as though the issuances were valid, one of the parties could lose a significant voting interest absent validation, the board members had purported to ratify the issuances, and the relevant stock was no longer in dispute. Thus, the Court held that the board approvals for the stock issuances were valid.

In contrast, with regard to another issuance, the Court held that the purported holder of the stock had not been able to establish when the board approved the issuance, and thus there was no corporate act to validate. With regard to a third issuance, the Court found that there was a corporate act because two of the directors had met with an intent to discuss board business, including the grant of the applicable shares. The Court then validated the board approval for this third issuance under the five-factor test, noting that prior to the litigation, the parties accepted a capital structure that incorporated the shares, the purported holders relied on the issuance, and one of the holders would be harmed if the issuance were not validated. The Court also considered other issuances, including a purported spin-off of a subsidiary corporation, under the two-part test.

CertiSign was a Delaware Court of Chancery action brought by CertiSign Holding Inc. (CHI) and another person pursuant to Section 205, seeking an order declaring that certain shares of putative stock were valid, and approving a corresponding stock ledger. Shortly after CHI's formation in 2005, the initial board of directors approved an amendment and restatement of CHI's original charter, which authorized several classes and series of stock. CHI then issued the stock to various parties in two transactions. However, the amended and restated charter was not filed with the Delaware Secretary of State until a few days after these issuances. When the error was discovered in 2012, CHI sought to take remedial steps, which would have required approval by the current directors and two of the original board members. One of the original board members, Sergio Kulikovsky, refused to assist. As a result, CHI filed the Chancery Court action. Kulikovsky intervened in the court proceedings and filed a corresponding counter-petition. Kulikovsky acknowledged that CHI would ultimately obtain relief, but contended that it would not be fair and equitable to grant CHI's requested relief without also determining the validity of other securities, some of which were held by him. CHI responded that the relief sought by Kulikovsky was subject to factual disputes that would require extended proceedings.

The Court noted that CHI's petition appeared to be tailor-made for Section 205 relief, given in part that all stockholders agreed that it arose from a ministerial error and all record stockholders signed written consents supporting it. In objecting to the petition, Kulikovsky relied on Section 205(d), which requires the Court to consider "[w]hether any person would be harmed or was harmed by the ratification or validation of the defective corporate act, excluding any harm that would have resulted if the defective corporate act had been valid when approved or effectuated." Kulikovsy claimed that he would be harmed if the Court did not also validate options awarded to him, because he would be unable to exercise the options and obtain shareholder rights, without which petitioners would be able to take whatever action they wanted without considering his rights as a shareholder. The petitioners responded that such harm could not prevent entry of relief because the Court was prohibited from considering "any harm that would have resulted if the defective corporate act had been valid when approved or effectuated." The Court ruled that Kulikovsky had not identified any persuasive reason why relief should not be granted, and granted petitioners' motion for partial judgment on the pleadings.

The *Numoda* and *CertiSign* decisions provide important guidance as to the type of actions to which Section 205 applies and the circumstances under which Delaware courts will grant relief. In determining whether to validate prior acts under Section 205, courts will first look for evidence of a "corporate act," through documentation such as organizational documents, official minutes, duly adopted resolutions, and a stock ledger, and through actions of the parties. Courts draw a distinction between informal intentions or discussions and corporate acts. Thus, Section 205 should be viewed as a tool for fixing ministerial errors and not as a backdating mechanism. Many of the same types of evidence used to show the existence of a corporate act are also relevant to the five-factor test used by courts under Section 205(d) to determine whether to validate the act. However, opponents of the validation cannot bootstrap objections by claiming a harm that would have resulted if the defective corporate act had been valid when approved.

» Read the Numoda Court of Chancery decision.

» Read the Numoda Delaware Supreme Court decision.

» Read the CertiSign decision.

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