Delaware Chancery Court Rules That Board Adoption of a "Super Vote Right" to Prevent the Election of an Insurgent Slate Breached Duty of Loyalty

On September 23, 2011, the Delaware Court of Chancery (per Vice Chancellor Laster) issued its decision in *Johnston, et. al.* v. *Ken Pedersen, et. al.,*[1] holding that directors had breached their duty of loyalty when they adopted and implemented a "super vote right" as part of the issuance of preferred stock for the purpose of preventing an insurgent slate of directors from being elected. Following a two-day trial, the Court issued an opinion in which it rendered the preferred stock super voting provision void and installed the plaintiffs' board slate. In reaching this conclusion the Court said of the defendants that "[a]though they honestly believed they were acting in the best interests of the company, they breached their duty of loyalty by structuring the [terms of the preferred stock] to prevent an insurgent group from waging a successful proxy contest."[2]

I. Background

Johnston was an action brought pursuant to 8 *Del. C.* §225, in which plaintiffs sought a determination of the validity of written consents removing defendant directors and replacing them with a new slate. Defendant directors argued that their removal or any election of a new slate without the majority consent of the Series B Preferred Stock stockholders should be ignored.

Xurex, Inc. ("Xurex" or the "Company"), an early stage company founded by Bo Gimvang, was involved in the development and sale of nano-technology coatings. Xurex's products had thus far proved to be failures and it had only one customer, DuraSeal, which accounted for 99% of its revenue. In the Company's early history, Gimvang and then CEO Bob Bishop raised $10 million in a private placement. As a result of this fund raising, Xurex had outstanding 32,046,313 shares of common stock and 15,069,850 shares of Series A Preferred Stock. The Series A Preferred shares had one vote per share and voted together with the common stockholders on an as-converted basis. Gimvang and Bishop controlled a majority of the voting power.

In 2009, Xurex faced a financial crisis and as a result had three successive control contests involving its board of directors. At the conclusion of these control contests, the board consisted of defendants who were not under the control of Gimvang or Bishop, plus one other individual loyal to Gimvang and Bishop.[3] This new board was concerned that Gimvang or Bishop, who still controlled a majority of the outstanding voting power of Xurex, would stage another coup. The incumbent board sought to stabilize the board and prevent another control contest. In addition, the Company needed to raise additional capital and in early 2010 the board "set out to kill two birds with one stone."[4] The board's plan was to raise capital through an equity issuance, which would provide the Company with additional reserves as well as dilute Bishop and Gimvang's majority voting block.

In April 2010, all stockholders were notified of the opportunity to participate in a bridge loan, the first step in the capital raising process. The bridge loan consisted of at least $300,000 in initial financing with the

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[1] C.A.No. 6567-VCL (Del. Ch. Sep. 23, 2011), available at http://courts.delaware.gov/opinions/download.aspx?ID=160910

[2] *Id. at 1.*

[3] The new board hired a new CEO who began to investigate allegations against Bishop and Gimvang for alleged misuse of Company funds. He found evidence to support these allegations and pursued them. This prompted Bishop and Gimvang to provide their proxy to the one board member in their camp, delegating the authority to him to remove the new CEO and the rest of the board, thus setting off the control contests. *Id* at 3.

[4] *Id*. at 7.

ability to convert into the Series B Preferred shares at a discount of 50% off the offering price.[5] There was no mention of the voting rights to be associated with Series B Preferred shares. The board had included very short time frames in which potential investors could respond to the offer. The Court inferred that this strategy was intended to ensure that loans ended up in friendly hands; either directors or stockholders who were personally solicited. The response date for participation in the offering was extended several times as board members had discussions with several of the larger stockholders about their investment concerns.[6] These stockholders indicated they would consider investing only if the then present board remained in control and that Bishop and Gimvang would not regain control of the Company. Thus, the discussion focused on how to structure the Series B Preferred shares to reduce Gimvang's influence. These discussions led to the inclusion of the "super vote right" as part of the financing terms.

In August 2010, subsequent to these stockholder discussions, the board authorized up to 20 million Series B Preferred shares. The Series B Preferred issuance carried one vote per share and voted with the common stock. It also included the "super vote right," which essentially granted Series B Preferred holders veto power over any matter subject to a vote of the Company's stockholders.[7] The Series B Preferred share offering closed in September 2010 and raised approximately $450,000. Over 60% of the capital raised came from converted principal and interest of the bridge loan.[8]

During the same time period, DuraSeal was in the process of being acquired by the Di Mase Group. As part of the acquisition, the Di Mase Group and DuraSeal's CEO realized it would be beneficial to combine Xurex and DuraSeal. To that end, DuraSeal's CEO negotiated an agreement to purchase 15 million Xurex common shares from Gimvang, as well as an irrevocable proxy to vote all of Gimvang's shares then owned or acquired in the future. At some point during its due diligence process on DuraSeal, Di Mase's attorneys discovered the class vote provision in Series B Preferred shares. As a result, in December 2010, DuraSeal attempted to buy $1 million of the Series B Preferred, but its offer was refused.[9]

The Di Mase Group completed its acquisition of DuraSeal by the end of 2010 and in April 2011, DuraSeal began to solicit proxies from Xurex stockholders. The purpose of these proxies was to remove the incumbent board and elect a new one.[10] On June 14, 2011, plaintiffs delivered written consents to Xurex to remove defendants from the board, fix the number of directors on the board at five and elect a new slate of

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5 The investment materials stated that directors would not participate in the offering unless initial commitments of at least $300,000 were not received. *Id.*

6 The board also waived deadlines for favored investors allowing them to participate in the offering up to two months after the participation date had passed.

7 "In addition to the [voting rights] in Section 4(a) hereof, so long as the shares of Series B Preferred remain outstanding, the affirmative vote or written consent of the holders of a majority of the outstanding shares of Series B Preferred, voting separately as a single class, shall be required for the approval of any matter that is subject to a vote of the Corporation's stockholders, whether or not a class vote is required by law." *Id.* at 12.

8 The private placement memorandum for the Series B Preferred shares established a maximum investment of $50,000 for anyone who had not participated in the bridge loan. *Id.* 13. The Court found that this was intended to result in a small group of stockholders controlling the class vote feature. *Id.* 14.

9 The Xurex board responded that the offering was closed, but that DuraSeal could purchase $1 million of common stock, an offer that was immediately declined. It was clear that the board understood DuraSeal was attempting to eliminate the obstacle to a proxy contest posed by the Series B Preferred voting provisions. *Id*. 16.

10 The Xurex board was informed of the proxy solicitation and started a counter solicitation. *Id.* at 17.

directors.[11] Also on June 14th, plaintiffs initiated the action to declare their written consents valid and effective. Defendants conceded that the consents represented a majority of the Xurex voting power and would be valid if not for the "super-vote" provision in Series B preferred shares.[12]

II. The Court's Decision

In its opinion, the Delaware Court of Chancery held Xurex board's adoption and implementation of the class vote provision for the Series B Preferred was a breach of its duty of loyalty under the enhanced scrutiny test required in a situation where a board of directors' actions affect the stockholder franchise.[13]

Enhanced Scrutiny

The Court applied the doctrine of enhanced scrutiny to this case because the board's action intruded on the stockholder franchise.[14] The Court discussed that under the enhanced scrutiny standard, the defendant directors have the burden to show their motivations "were proper and not selfish, that they did not preclude stockholders from exercising their right to vote or coerce them into voting in a particular way, and that the directors' actions were reasonably related to a legitimate objective" when applied to a director action affecting a stockholder vote. In this instance, the Court stated such action must be supported by a compelling justification as it concerned corporate control.

The Court determined that defendant directors adopted the "super vote right" class provision in the Series B Preferred shares to prevent holders of a majority of Xurex's outstanding common stock and Series A Preferred shares from electing a new board. The directors argued the provision was necessary to entice investors to supply the necessary operating capital for Xurex to continue in business. However, the directors also admitted they wanted to preserve the incumbent board, as they believed stability was in the Company's best interests. On this point, the Court concluded that even though the directors acted in good faith, they could not be deemed to have acted loyally while simultaneously depriving stockholders of their right to elect new directors.[15] The Court also opined that even if the board's subjective intent was only to raise capital, there was still no compelling justification for issuing Series B Preferred shares with a class vote as structured. Part of the reasoning for this conclusion was that based upon the Company's own valuation, the board's issuance of the bridge loan and Series B Preferred shares sold negative control of the Company for only 12.2% of its value.[16]

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[11] According to the plaintiffs, three out of the five directors proposed were independent. *Id.* at 17.

[12] The plaintiffs declared that the written consents consisted of approximately 69% of the common stock, 51% of the Series A Preferred Stock and 13% of the Series B Preferred stock. *Id.* at 18.

[13] "Enhanced scrutiny is Delaware's intermediate standard of review. *Reis v. Hazelett Strip-Casting Corp*., 2011 WL 4346913, at *8 (Del. Ch. Jan. 21, 2011). It applies "when the realities of the decision making context can subtly undermine the decisions of even independent and disinterested directors." *Id.* at 18-19.

[14] *See Mercier v. Iner-Tel* (Del.), 929 A.2d 786, 810-11 (Del Ch. 2007). "Enhanced scrutiny also applies in other situations where the law provides stockholders with a right to vote and the directors take action that intrudes on the space allotted for stockholder decision-making." Reis, 2011 WL 4346913, at *8.

[15] "The notion that the directors know better than the stockholders about who should be on the board is no justification at all." *Mercier*, 929 A.2d at 811; accord *Blasius Industries, Inc. v. Atlas Corp*, 564 A.2d 651 at 663 (Del. Ch. 1988). *Id.* at 21.

[16] Defendant director Pedersen also admitted that the class voting provision was broader than needed to obtain the capital. *Id.* at 21. *Johnston* at 22.

Similarly, the Court found the process by which the bridge loan and Series B Preferred shares were offered was not sufficiently tailored to a capital-raising purpose. As discussed above, the Court highlighted the short time frame in which investor responses were requested and also the absence of information about the terms of the Series B Preferred in the offering materials. Additionally, the "highly material information" about class vote rights was only disclosed to management-supporting stockholders. Consequently, although it appeared that offers were open to all stockholders, in truth that the offering shifted negative control into mostly friendly hands.

The Court's decision concluded the defendant directors breached their duty of loyalty in issuing the Series B Preferred shares, even though the Court believed the defendants acted in good faith.[17]

Remedy

The Court held that since the defendant directors breached their duty of loyalty, the Series B Preferred shares were not entitled to vote as a class.[18] The Court ruled that the plaintiff directors were validly elected by the written consents.

III. Significance of the Decision

In *Johnston*, the Delaware Chancery Court ruled that when a board of directors seeks to limit or alter the stockholder franchise, it is held to a much higher standard of conduct. This standard allowed the Court to find that even though the directors acted in good faith and in their opinion in the best interests of the Company, they were still deemed to have breached their duty of loyalty.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com; or Ross Sturman at 212.701.3831 or rsturman@cahill.com.

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[17] "Fiduciaries who are subjectively operating selflessly might be pursuing a purpose that a court will rule is inequitable." *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1121 (Del. Ch. 1990); *see Blasius*, 564 A.2d at 663 (concluding that good faith conduct constituted an unintentional violation of the duty of loyalty). *Id.* at 23.

[18] The Court declined to institute any further remedy as an action under Section 225 is limited in scope to the issues that pertain to "the validity of actions to elect or remove a director or officer" *See Genger v. TR Investors, LLC*, __A.3d __, ___, 2011 WL 2802832, at *13 (Del. July 18, 2011). *Id*. at 24.

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