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Delaware Corporate and Alternative Entity Law Update

Special points of interest:

- New Arbitration Procedures
- Fairness Standard
- Statute of Frauds
- Board Reduction
- LLC Member Fiduciary Duties
- Insider Trading
- Documents Under Seal
- Special Litigation Committee
- Good Faith and Fair Dealing
- Legislative Updates

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Chancery Court Adopts Arbitration Rules

The Delaware Court of Chancery adopted rules governing arbitration hearings, as authorized by the Delaware General Assembly in 2009 (see H.B. 49, 145th General Assembly). The rules, which went into effect February 1, 2010, provide for parties engaged in business disputes to voluntarily submit to arbitration by a judge or master of the Court of Chancery. For business disputes involving claims for monetary damages only, the amount in controversy must exceed one million dollars. Arbitration proceedings are commenced when the parties submit a petition for arbitration to the Register in Chancery. Once appointed by the Chancellor, the Arbitrator will contact the parties' counsel to set a preliminary telephonic conference, to be held within ten days after commencement of the arbitration, where the parties and/or their attorneys obtain additional information about the nature of the dispute, scheduling, and conflicts, and consider whether

mediation or a different alternative dispute resolution procedure could be appropriate. A preliminary hearing then takes place as soon as practicable after the preliminary conference. The preliminary hearing provides the parties the opportunity to consider services of statements of claims, issues, damages and defenses, stipulations of fact, the scope of discovery, exhibits, witnesses, depositions and subpoenas, and the length of the hearing. The arbitration hearing will generally occur no later than 90 days after receipt of the petition. The hearing is to be attended by at least one representative of each party with authority to resolve the matter as well as by Delaware counsel for each party. The hearings are private, and the memoranda and work product contained in the case files of the Arbitrator are confidential. The Arbitrator is permitted to grant any just and equitable remedy or relief that is within the scope of any applicable agreement of the

parties, and upon the granting of a final award, a final judgment or decree will be entered and enforced as any other judgment or decree. The Arbitrator also has the power to make other decisions, such as interim, interlocutory or partial rulings, orders and awards. The parties to the arbitration may stipulate that the adjudication will be non-appealable. The rules provide flexibility to the parties, permitting them, with the consent of the Arbitrator, to change any of the arbitration rules and/or to adopt additional rules. Offering a cost-effective option for resolving disputes, the Chancery Court's arbitration option should help fulfill the General Assembly's goal of keeping the Court "at the cutting-edge in dispute resolution."

Link to Chancery Court Rules:

Click [Here](#)

Link to H.B. 49:

Click [Here](#)

Chancery Court Applies Entire Fairness Standard to Controlling Stockholder, Permits Duty of Disclosure Claim to Proceed

In the case *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009) the Delaware Chancery

Court applied the entire fairness standard to a breach of fiduciary duty claim against the controlling stockholder of John Q. Hammons Hotels Inc.

The case arose out of a merger in which the namesake of the hotel enterprise, who controlled approximately 76% of the total vote, received a pre-

In re John Q. Hammons Hotels Inc. Shareholder Litigation cont'd.

ferred interest in the surviving entity, \$300 million in credit, and various contracts with the purchaser. Minority shareholders alleged that Hammons breached his fiduciary duties by negotiating benefits for himself, and that the directors approved the sale in a deficient process with less than full disclosure. The Court declined to apply an entire fairness review to the transaction, since Hammons did not stand on both sides of the transaction. Nonetheless, the Court found that the requirements for application of the business judgment rule – robust procedural protections to protect the minority’s bargaining power and ability to make an informed decision – were not met either. Specifically,

the special committee of the board authorized to review the merger had been given the power to waive the requirement that a majority of the minority stockholders approve the merger, and the vote required a majority of voting stockholders, not a majority of all of the minority stockholders. Although the majority of the minority vote was not waived and although a majority of all of the minority stockholders did in fact approve the merger, the lack of a non-waivable majority of the minority vote persuaded the Court to apply the entire fairness standard. The plaintiffs alleged that Hammons’ self-dealing over the years depressed the stock price, subjecting the special committee

of the board to coercion, and the Court found sufficient factual disputes to deny summary judgment on the basis of entire fairness and to deny summary judgment with respect to claims against the merger acquisition vehicles for aiding and abetting the alleged breaches of fiduciary duty. Regarding the disclosure claims, the Court found that while the board was not required to characterize its role in the merger as subservient and deferential in the proxy statements, potential conflicts of interests existed with respect to the investment advisor (who sought to underwrite a post-merger mortgage-backed security offering by the purchaser) and the law firm advising the non-employee mem-

bers of the Board regarding the offer (who also represented the entity providing the purchasers’ financing). Noting that the potential conflicts of interest of the special committee’s advisors are important facts, the Court held that evidence that the advisor’s opinion was actually affected was not a pre-requisite to disclosure, and that the special committee’s waiver of a conflict would itself be a matter important to stockholders in evaluating the transaction.

Link to Court Opinion:

Click [Here](#)



Delaware Supreme Court Applies Statute of Frauds to Agreements

In *Olson v. Halvorsen*, 986 A.2d 1150 (Del. Supr. Dec. 15, 2009) the Delaware Supreme Court held that the statute of frauds applies to limited liability company agreements. The plaintiff, co-founder of hedge fund Viking Global, alleged that the founders had orally agreed to amend their LLC’s compensation provisions to implement earnouts for departing founders, offering an unsigned draft LLC agreement and an additional

agreement referencing the LLC agreement as evidence. The Chancery Court had granted summary judgment for the defendants, finding that the plaintiff had failed to prove that the original compensation agreement had been superceded. Although the Supreme Court admitted that upholding the Chancery Court’s factual findings made it unnecessary to reach the statute of frauds issue, because of the issue’s impact “on the drafting and

enforcement of LLC agreements,” the Court clarified that the statute of frauds does not conflict with the legislative policy of giving “‘maximum effect’ to LLC agreements.” Noting that over the years the General Assembly has expanded the recognition of LLC agreements to include oral and implied agreements, the Court held that the Legislature did not intend the LLC Act to repeal the statute of frauds or to remove LLC agreements

from their effect. Rather, the General Assembly has provided flexibility in permitting “more types of LLC agreements,” each of which is subject to the statute of frauds. On April 29, 2010 the Delaware House of Representatives passed H.B. 372, which, if enacted, would repeal *Olson* (see page 6).

Link to Court Opinion:

Click [Here](#)

Delaware Supreme Court Rejects Board Reduction Procedure

In *Crown EMAK Partners, LLC v. Kurz*, 2010 WL 1610487 (Del. Supr. Apr. 21, 2010), the Supreme Court upheld the Chancery Court’s invalidation of bylaw amendments that purported to reduce the size of board of directors

below the number of sitting directors. During a struggle for control of EMAK Worldwide, Inc., the defendant, holder of EMAK’s Series AA Preferred Stock, delivered consents to amend EMAK’s bylaws to shrink the board

from seven to three members. At the time, five board members were seated. Under the terms of the Preferred Stock, the defendant had the right to appoint two directors; according to the bylaw amendments, a special meeting of stockhold-

ers would be called to elect the third director. Noting that neither the DGCL nor the Delaware courts have addressed this method of removing directors, the Chancery Court held that the bylaw amendments conflicted with

Supreme Court Rejects Board Reduction Procedure cont'd.

the DGCL’s provisions on director election and removal, as well as with quorum requirements. The Supreme Court affirmed this holding, noting that DGCL §141(b) enumerates the methods by which a director’s term can end: either through the election and qualification of his successor, his resignation, or his removal. The Supreme Court also upheld the Chancery Court’s rejection of the argument that displaced directors could remain in a liminal seatless state until their terms were terminated by one of the 141(b) methods, noting that §141(b)

“does not contemplate a board with more directors serving than the ‘number fixed by their bylaws.’” Furthermore, because quorum requirements are calculated based on the number of directorships (as opposed to the number of directors in office), a board with surplus unseated directors would reduce the percentage of directors needed to constitute a quorum, in conflict with the mechanisms of §141(b). Finally, by calling for a special election to elect a single successor to multiple occupied seats, the bylaw amendments ran afoul of the election

framework articulated in DGCL §221, which differentiates between stockholder action at an annual meeting and what can be accomplished by stockholder action between annual meetings. The Court noted that under §221(b), stockholders seeking to elect directors by written consent in lieu of an annual meeting must proceed by unanimous consent, unless all of the directorships available to be filled at the annual meeting are vacant and are filled by such consent. Therefore, stockholders are not permitted to use “a non-unanimous consent to remove

lawfully serving incumbent directors, and then elect successor directors, between annual meetings,” as the defendant had purportedly done.

Link to Chancery Court Opinion:

Click [Here](#)

Link to Supreme Court Opinion:

Click [Here](#)

Chancery Court Applies Traditional Fiduciary Duties to LLC Members

In *Kelly v. Blum*, 2010 WL 629850 (Del. Ch. Feb. 24, 2010), the Chancery Court examined fiduciary duties in the LLC context, holding that an LLC agreement that limited liability for breaches of fiduciary duties to “willful violations” precluded application of the entire fairness standard, but did not explicitly alter the default fiduciary duties of loyalty and care. The plaintiff, former member, manager and president of an LLC formed to run a Philadelphia area radio

station, alleged that the other managers engaged in a self-dealing merger that left the company in the hands of the other members and their affiliates. The Court noted that Delaware cases interpreting the Delaware Limited Liability Company Act have concluded that unless the LLC agreement “explicitly expands, restricts, or eliminates traditional fiduciary duties, managers owe those duties to the LLC and its members and controlling members owe those duties to

minority members.” The Court read the exculpation clause in the LLC Agreement as intending that traditional fiduciary duties would apply; however, in order to proceed the plaintiff would have to plead facts that, if true, would support a finding of a willful breach of contractual or fiduciary duties. The Court further noted that the exculpation provision “requires more than application of a standard like entire fairness” and would necessarily require the plaintiff

to allege facts to show scienter. Finding that the plaintiff had met his burden as to his fiduciary duty claims, the Court allowed those claims to proceed.

Link to Court Opinion:

Click [Here](#)



Chancery Court Affirms State Law Insider Trading Claims

In *Pfeiffer v. Toll*, 989 A.2d 683 (Del. Ch. March 3, 2010), the Court of Chancery affirmed the application of an insider trading “*Brophy* claim” against various directors of housing builder Toll Brothers in connection with their sale of \$615 million in stock months before the company downgraded its earnings expectations. The defendants claimed

that the state claim for breach of fiduciary duty through insider trading authorized in the 1949 case *Brophy v Cities Service Co.* was pre-empted by and duplicative of federal insider trading laws. In asserting that *Brophy* is still good law, the Court noted that a *Brophy* claim is derivative in nature and is intended to remedy harm to the corporation

suffered by a breach of the duty of loyalty. While disgorgement may theoretically be an appropriate remedy under a *Brophy* claim, there are several other types of harm for which recovery could be made, such as costs and expenses incurred in dealing with federal securities claims. The Court next held that federal law not only provides

space for state fiduciary claims based on insider trading to exist, it actually depends on the existence of a fiduciary or similar relationship of trust and confidence in order to trigger liability. Therefore, according to the Court, “if Delaware were to hold that the fiduciary duties of directors and officers did not limit their insider trading, the corner-

Chancery Court Affirms State Law Insider Trading Claims cont'd.

stone of the federal system would be removed.” Finding that maintaining *Brophy* claims serves Delaware’s strong pub-

lic policy of policing against violations of the fiduciary duty of loyalty and does not conflict with federal securities laws,

the Court refused to dismiss the claims against the direc-

Link to Court Opinion:

Click [Here](#)

Delaware Courts Examine “Documents Under Seal”

Two recent cases discuss the requirements for a “document under seal” for purposes of extending the statute of limitations on such contracts from three years to twenty. In *Whittington v. Dragon Group, LLC*, 991 A.2d 1 (Del. Supr. Dec. 18, 2009), the Delaware Supreme Court reviewed the conflicts in the Delaware trial courts, ultimately adopting the rule established in the 1940 Orphan’s Court case *In re Beyea’s Estate*. According to the Court, “in the case of an individual, in contrast to a

corporation, the presence of the word ‘seal’ next to an individual’s signature is all that is necessary to create a sealed instrument, irrespective of whether there is any indication in the body of the obligation itself that it was intended to be a sealed instrument.” In dissent, Justice Jacobs argued that the majority rule represents an “inadvisable policy choice” and that the “use of the boilerplate term ‘seal,’ without more, should be insufficient to visit twenty years of exposure to litigation upon

contracting parties.” In a letter opinion in *Sunrise Ventures, LLC v. Rehoboth Canal Ventures, LLC*, 2010 WL 975581 (Del. Ch. March 4, 2010), the Chancery Court applied *Whittington* to a dispute alleging breach of an LLC agreement. In the opinion the Chancery Court noted that the LLC agreement at issue contained a testimonium clause but not the word “SEAL” next to the parties’ signatures. Finding that “*Whittington* did not hold that a contract containing only a

testimonium clause creates a contract under seal,” the Chancery Court held that the plaintiff’s claims were time-barred.

Link to Supreme Court Opinion in *Whittington* :

Click [Here](#)

Link to Chancery Court Opinion in *Sunrise Ventures*:

Click [Here](#)

Chancery Court Criticizes Special Litigation Committee, Permits Suit to Proceed

In *London v. Tyrrell*, 2010 WL 877528 (Del. Ch. Mar. 11, 2010), the Chancery Court denied a Special Litigation Committee’s motion to dismiss a derivative lawsuit, finding that material issues of fact existed regarding the Committee’s independence and the reasonableness of its conclusions. The suit involved a claim that the Board of iGov, a government contract firm, authorized an equity incentive plan that granted discounted stock options to certain directors and senior executives, 60% of which went to the defendants and none of which went to the plaintiffs. The plaintiffs, former iGov directors, alleged that the strike price on the stock options was artificially low and based on an outdated and incomplete

valuation that varied greatly from other valuations produced for internal use and for delivery to creditors. Analyzing the plaintiff’s claims that the defendant directors breached their duties of loyalty and care, the Committee, made up of two Board members who succeeded the plaintiffs on the Board, determined that it would not be in the best interests of iGov to pursue the claims. The Court found that the Committee had not met its burden of showing independence, since one member was the husband of one of the defendant’s cousins, and the other had supervised the same defendant at another company for years, promoting him from internal auditor to CFO. The Court also found that the Committee had not conducted

a good faith investigation into the plaintiff’s claims nor demonstrated the reasonableness of its conclusions. According to the Court, the Committee failed to interrogate the defendants adequately regarding the discrepancies between and the inconsistencies within the valuations. Instead the Committee accepted the defendants’ explanations at face value. The Committee also recommended dismissal of the duty of care claims based on the exculpatory provision in the company’s charter, even though one count of the complaint demanded rescission of the equity incentive plan, a remedy which is not subject to that provision. After reviewing numerous additional instances of failure to investigate the issues further, the Court

determined that there were material questions as to whether the Committee had a reasonable basis to conclude that the strike price on the stock options was fair and refused to dismiss the lawsuit.

Link to Court Opinion:

Click [Here](#)



Delaware Supreme Court Rejects Allegation of Good Faith and Fair Dealing Violation

In *Nemec v. Sharader*, 2010 WL 1320918 (Del. Supr. Apr. 6, 2010), the Delaware Supreme Court held that Booz Allen's redemption of stock from retired directors prior to the sale of its government business to The Carlyle Group did not violate the implied covenant of good faith and fair dealing. The stock purchase was made pursuant to a Stock Rights Plan, which permitted the company to redeem the retired directors' stock at book value at any time beyond the two-year anniversary of their retirement. The plaintiffs retired in March 2006, and the Carlyle sale was originally expected to close by March

31, 2008. After the closing was delayed, the company bought the plaintiff's stock, comprising about 11% of the outstanding common stock, at approximately \$163.46 per share. In May 2008, Booz Allen announced the \$2.54 billion sale, which netted its stockholders over \$700 per share. The plaintiffs argued that by exercising the redemption option, the company had denied them the opportunity to participate in the Carlyle sale. The Chancery Court dismissed the suit for failure to state a claim and the Supreme Court affirmed in a 3-2 decision. Noting that the implied covenant of good faith and fair

dealing generally is not implicated for conduct authorized by the contract, the majority found that the parties received exactly what they bargained for under the Stock Plan, and that there was nothing to support an inference that if the parties had addressed the possibility of a private equity, post-retirement buyout at the time of contracting, they would have prohibited the redemption prior to closing. The majority further noted that the company received a \$60 million benefit due to the redemption and argued that the Board could have faced a suit for breach of fiduciary duties if it had failed to take the op-

portunity to get this benefit. In dissent, Justice Jacobs argued that even though the contract permitted the redemption, a contracting party exercising its contractual power arbitrarily or unreasonably may still be in violation of the implied covenant of good faith and fair dealing. Because the complaint alleged that the redemption served no legitimate interest of the company, the dissent argued that claim should be allowed to proceed.

Link to Court Opinion:

Click [Here](#)

Changes to the Delaware General Corporation Law

Click on the highlighted text to be directed to the affected Sections of the DGCL

Administration of Corporate Franchise Tax: [H.B. 297](#) with H.A. 1 was signed into law on January 26, 2010, amending [§503\(i\)](#) of the DGCL to eliminate the provision barring a corporation from consolidating its assets with the assets of another entity for purposes of the franchise tax in light of the other provisions in that section requiring a corporation that reports its total assets on a consolidated basis to submit a reconciliation to the Secretary of State. The bill also eliminates DGCL [§506](#), which required the Secretary of State to maintain at all times a fund of \$5,000 to \$70,000 for the payment of refunds of corporation franchise taxes.

Amendments to the DGCL Concerning Nonstock Corporations: [H.B. 341](#) was signed into law on May 3, 2010. The bill provides a comprehensive update to the DGCL to address nonstock corporations, of which there are currently approximately 18,000 incorporated in Delaware. The bill amends [§102\(a\)\(4\)](#) to allow nonstock corporations to put the conditions for membership or other criteria for identifying members in the certificates of incorporation or bylaws, and to provide for classes or groups of members with differing levels of voting rights. The bill also adds a new "translator" section 114 to the DGCL, which establishes which provisions of the DGCL apply to nonstock corporations generally and which provisions apply specifically to non-profit nonstock corporations. Amendments to [§215](#) in the bill apply [§§211\(d\)](#) and [212\(e\)](#)

to nonstock corporations, permitting special meetings of members and providing for irrevocable proxies, respectively. A new [§215\(f\)](#) also provides a default rule that the record date for meetings for nonstock corporations shall be deemed to be the date of the meeting, so long as no record date precedes the action by the governing body fixing the record date. The bill permits a nonstock corporation to effect a short-term merger with a subsidiary in which it owns 90% of the outstanding shares of each class of stock otherwise entitled to vote on a merger, provided that the nonstock corporation is the survivor. The bill also contains amendments to [§255](#) to dispense with the need for two votes to authorize a merger and to decrease the necessary votes from the governing body from two-thirds to a majority. New provisions also permit a

nonstock corporation to revoke a dissolution effected by it and to redomesticate in any foreign jurisdiction in a manner analogous to a nonstock corporation. The provisions of [H.B. 341](#) are to be effective as of August 1, 2010.



Changes to Delaware Corporate and Alternative Entity Law

On April 29, 2010, the Delaware House of Representatives passed bills amending the [Delaware Limited Liability Company Act \(H.B. 372\)](#), the [Delaware Revised Uniform Limited Partnership Act \(H.B. 373\)](#), the [Delaware Revised Uniform Partnership Act \(H.B. 374\)](#) and the [General Corporation Law \(H.B. 375 w. H.A. 1\)](#). Among the highlights of the legislation, which would be effective August 2, 2010 if signed into law are:

The LLC Act, DRULPA and DRUPA are amended to provide that neither a limited liability company agreement nor a partnership agreement are

subject to the statute of frauds. This revision was made in response to the Delaware Supreme Court’s decision in *Olson v. Halverson* (see page 2) subjecting a putative amendment to an LLC Agreement to the Statute of Frauds.

The LLC Act, DRULPA, DRUPA and DGCL are amended to allow for electronic service of process upon the Secretary of State and authorizes the Secretary of State to issue rules and regulations to effectuate this process.

The LLC Act, DRULPA, DRUPA and the DGCL are amended to provide a mecha-

nism to implement a short-form merger under new Section 267 of the DGCL of a subsidiary corporation or corporations and a parent non-corporate entity.

The LLC Act, DRULPA, DRUPA and DGCL are amended to clarify that unless otherwise provided in a limited liability company agreement or partnership agreement, a limited liability company or partnership has the power and authority to grant, hold or exercise a power of attorney, including an irrevocable power of attorney.

The DGCL is amended to

clarify that the decision to include either a copy or a summary of a proposed amendment to the certificate of incorporation in a notice of a stockholder meeting need not be approved by a specific act of the board of directors, and that in a merger the certificate of incorporation of the surviving corporation may be amended and restated in its entirety.

On May 4, 2010, the bills were assigned to the Senate Judiciary Committee for further consideration.

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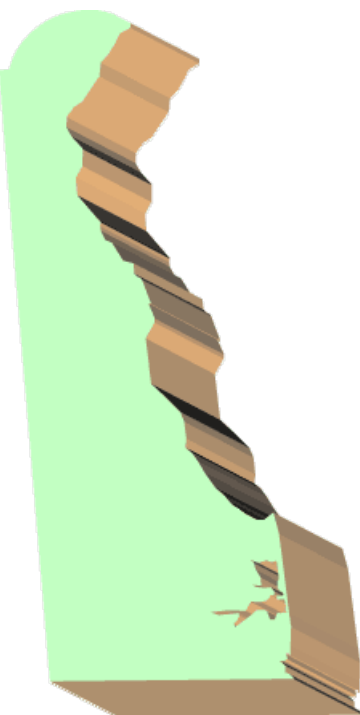
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Delaware Corporate and Alternative Entity Law Update

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