Delaware Law Weekly

www.delawarelawweekly.com

December 15, 2010

An ALM Publication

Equity Offers No Forgiveness if Statutes Are Skirted

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Special to the DLW
Delaware Law Weekly
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The Court of Chancery's recent post-trial opinion in Blades v. Wisehart drives home a point grounded in Delaware Supreme Court precedent decided two decades ago: Strict compliance with statutory requirements is necessary in transactions involving changes to the capital structure of Delaware corporations. Under Blades, decided by Vice Chancellor Leo E. Strine on Nov. 17, forward stock splits fall squarely within this mandate.

Blades involved an action brought under Section 225 of the Delaware General Corporation Law, or DGCL. It sought, among other things, a declaration of the validity and scope of a unanimous written consent purporting to effect the removal and corresponding replacement of directors of Global Launch Inc., a company created to facilitate layaway purchasing over the Internet.

At play was an attempt by a newly elected slate of directors backed by Global's original stockholders -- Global founder Rusty Blades and an Ohio corporation aptly named "The Ohio Company" -- to wrest control from an incumbent faction led by the defendants.

According to the opinion, the power struggle implicated a lengthy procession of prior corporate acts, including the following.

The initial Global shareholder agreement executed in December 2007 provided that the board could be changed only by an affirmative vote of 80 percent of the shares outstanding, roughly two-thirds of which were owned by Blades and the other third by The Ohio Company. In early 2008, that agreement was amended to eliminate this restriction.

The intention of the original Global shareholders and board had been to raise capital by selling stock to investors and, on the part of Blades, to motivate employees with gifts of Global stock. To realize these objectives, the board intended to increase the number of Global's authorized shares from 10 million to 50 million, then effect a one for five stock split of the shares held by Blades and The Ohio Company. The board's Ohio counsel sought to accomplish this by a resolution claiming to reflect the unanimous vote of the shareholders and directors to amend the Global charter to authorize the issuance. The corresponding certificate of amendment stated that it would be effective on May 1, 2008, but it was not filed with the secretary of state (and thus was not effective under Delaware law) until December 2008. Critically absent was any evidence of a board resolution actually authorizing the split or a shareholder vote approving such a resolution.

Throughout 2008, stock was marketed to new investors and transferred to employees roughly in accordance with Blade's express wishes -- all on the assumption that the split had occurred as intended. The former occurred through subscription agreements. The latter transfers, however, were poorly documented, violated certain provisions of the Global shareholder agreement, and appeared to have been made without Blades' consent or knowledge. As a result of these stock transactions, Blades and The Ohio Company would have been left with only 52 percent of the Global shares in total.

In November 2008, Blades resigned from the Global board after pleading guilty to a misdemeanor in an unrelated case, the opinion said. Thereafter, he was increasingly kept in the dark about Global.

After unsuccessfully attempting to cause the board to hold an overdue annual meeting in August 2009, Blade persuaded an ally on the board to give notice a meeting, though a single director was not so authorized. Notice issued to all shareholders listed on the stock ledger, and the meeting was held on Nov. 18, 2009. At the meeting, seven new directors purportedly were

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elected, including Blades. Immediately following the meeting, the new board undertook a litany of actions, ranging from the adoption of bylaw amendments to the removal and replacement of Global officers and the cancellation of stock transfers.

Recognizing later that the Nov. 18 meeting had been called without the requisite authority, and at this point assuming that the 2008 stock split had not been effected, Blades and The Ohio Company (believing that they were the only two legitimate Global shareholders) executed a unanimous written consent this March. The consent purported to do two things: ratify the actions taken by the board and replace the prior slate of directors with the directors "voted in" at the Nov. 18 meeting. That same day, the new board filed the Section 225 action.

Thus, the validity of the consent ultimately hinged on a single question: whether or not the 2008 stock split intended to facilitate the transfer of Global shares to minority investors and other parties had been validly implemented. If the stock split had occurred, the consent at issue would not be valid. If the stock split were determined to be ineffective, Blades and The Ohio Company would be the only shareholders in Global, and thus had the voting power necessary to execute the disputed consent and remove the directors.

Where Equity Doesn't Shine

The court analyzed the actions taken and not taken in connection with the stock split by the incumbent Global board under DGCL Section 242(b)(1), which delineates the specific requirements for charter amendments. Compliance was found to be lacking on every level.

First, while the 2008 resolution purported to authorize the issuance of 50 million Global shares, there was no duly adopted resolution setting forth a proposed amendment actually effecting the split, declaring its advisability, and providing for a shareholder vote at a special meeting or the next annual meeting. Nor was there any evidence that the proposed amendment had been submitted to the shareholders for adoption by written consent.

Second, there was no evidence that proper notice of the proposed amendment had issued.

And third, the requisite certificate setting forth the amendment and certifying adoption was never executed and filed in accordance with DGCL Section 103.

Citing ample evidence indicating that Blades -- now arguing against the stock split -- previously had acted on the assumption that the split had been effected, the incumbent directors argued that their technical non-compliance with DGCL Section 242 should be overlooked and that equity should carry the intended results of their actions.

Observing that the equities did not favor the defendants in any event, the vice chancellor turned to the Supreme Court's 1990 holding in Waggoner v. Laster and its 1991 decision in STAAR Surgical Co. v. Waggoner. Together these cases make clear "that law trumps equity in this area of corporate decision making."

The driving concern is that the capital structure and ownership of corporations are "'matters of great importance and should be settled with clarity,'" the vice chancellor wrote, quoting the 2002 Chancery Court case Liebermann v. Frangiosa. Thus, a party affecting these fundamental interests through an amendment to the corporate charter must scrupulously adhere to statutory formalities.

The Blades opinion emphasized that while STAAR and Waggoner involved the issuance of new stock, the scrupulous adherence requirement was equally applicable to stock splits. Quoting STAAR, the vice chancellor noted that stock splits, like the issuance of new stock, "'rightly can be seen as an act of fundamental legal significance having a direct bearing upon questions of corporate governance, control and the capital structure of the enterprise.'"

Underscoring just how inflexible the scrupulous adherence requirement is, the vice chancellor emphasized that temporal compliance with Section 242 also was required. That is, not only must all of the requisite steps be taken in strict conformity with the applicable statute, they must be taken in the proper order, and that sequence may not be altered even by charter provision.

So, Blades instructs once again that in matters bringing change to a firm's capital structure, strict compliance with statutory requirements -- both substantive and temporal -- is absolutely necessary. In this transactional arena, equity offers no forgiveness. •