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December 4, 2008

BRIEF: Noe v. Kropf: Intervenor's Memorandum of Law -- Filed December 4, 2008 -- in the Delaware Court of Chancery citing Bigler & Tillman's Void or Voidable? -- Curing Defects in Stock Issuances Under Delaware Law

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IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

WILLIAM M. NOE, and
O. RUSSELL CRANDALL,

Plaintiffs,

v.

ROBERT KROPF, JAMES R. HERBERT,
and TRACY GNAGY,

Defendants,

and

TURNAROUND ADVISORS, LLC.,

Intervening Defendant,

and

AMERISTAR NETWORK, INC.,

Nominal Defendant.

C.A. No. 4050-CC

**INTERVENOR TURNAROUND ADVISORS LLC'S (1)OPPOSITION TO PLAINTIFFS'
MOTION FOR DEFAULT JUDGMENT, MOTION FOR JUDGMENT ON THE
PLEADINGS AND MOTION FOR ATTORNEYS' FEES AND COSTS; AND
(2) OPENING BRIEF IN SUPPORT OF ITS MOTION FOR ATTORNEYS' FEES AND
COSTS**

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between void stock and voidable stock in the context of a stock issuance defective under the DGCL.⁴² The Court of Chancery recently acknowledged that the law as to when and whether a defective stock issuance is curable “is not as clear as it could be.”⁴³ In other cases, save one,⁴⁴ the provisions of the DUCC have not been discussed in the context of stock issuances that are technically deficient under the DGCL.⁴⁵

Plaintiffs dispute that Delaware law is moving away from the rigid rule they articulate⁴⁶ and toward a position that “where stock is held by an innocent third-party purchaser, technical defects relating to statutory formalities should not lead to a finding of void stock, but at worst to a finding of voidable stock.”⁴⁷ Delaware courts have “demonstrated a willingness to look beyond statutory violations to the equitable result caused by voiding the stock.”⁴⁸ For example, *Kalageorgi v. Kamkin, Inc.* was a Section 225 action, affirmed by the Delaware Supreme Court, where the plaintiffs held thirty-nine shares, sixty-one shares were issued to the defendants, and

⁴² See C. Stephen Bigler and Seth Barrett Tillman, *Void or Voidable?—Curing Defects in Stock Issuances Under Delaware Law*, 63 BUS. LAW. 1109 (2008) (citing cases).

⁴³ See *MBKS Co. Ltd. v. Reddy*, 924 A.2d 965, 972 (Del. Ch. 2007), *aff’d*, 945 A.2d 1080 (Del. 2008).

⁴⁴ See *id.*

⁴⁵ See Bigler and Tillman, *supra* at 1111. Plaintiffs continue to rely on the same cases for the proposition that if a corporation issues stock in violation of Section 151 of the DGCL, then the shares of such stock are legal nullities and void as a matter of law. Pl. Second Default Mot. at ¶ 12-13. For example, in *Staar Surgical Co. v. Waggoner*, 588 A.2d 1130 (Del. 1991), although there the Delaware Supreme Court held that stock issued in violation of Section 151 of the DGCL is invalid and void, that case did not involve a “protected purchaser.” *Id.* at 1134, 1136-37. In fact, in *Staar*, the Supreme Court simply rejected the defendants’ argument that even though the stock was technically defective the defendants were equitably entitled to an order, akin to specific performance, treating the stock as if it were validly issued, as consideration for the defendants’ personal guarantee of the company’s debt. *Id.* The other cases cited by Plaintiffs also did not involve a “protected purchaser.” See, e.g., *Waggoner v. Laster*, 581 A.2d 1127 (Del. 1990) (not involving a “protected purchaser”); *Superwire.com, Inc. v. Hampton*, 805 A.2d 904, 909 (Del. Ch. 2002) (same); *Kalageorgi v. Kamkin, Inc.*, 750 A.2d 531 (Del. Ch. 1999), *aff’d*, 748 A.2d 913 (Del. 2000) (same).

⁴⁶ See Pl. Second Default Mot. at ¶¶ 19-21.

⁴⁷ See Bigler and Tillman, *supra* at 1148-49.

⁴⁸ *Id.* at 1149.

the plaintiff claimed to be the sole *de jure* stockholder because the sixty-one shares purportedly issued to defendants had not been validly authorized by the corporation's board of directors.⁴⁹ If the shares were validly issued, then the slate of directors elected by the defendants properly constituted the corporation's board of directors; otherwise, the plaintiff was the sole stockholder and director.⁵⁰ The Court of Chancery never reached the question of whether the shares were validly issued *ab initio*. Rather, the Court of Chancery in *Kalageorgi* held that the defective shares were capable of being cured by retroactive ratification by the director defendants.⁵¹ Thus, *Kalageorgi* stands for the proposition that stock issuances defective under the DGCL are not necessarily null and void.

Similarly, in *Bowen v. Imperial Theaters, Inc.*, the Court of Chancery recognized the importance of an "innocent purchaser" in a situation where it was alleged that a stock issuance was void.⁵² Although the Court of Chancery found that the complainant was not an innocent purchaser, it stated that if the complainant "did purchase for value without notice of the infirmity in [the complainant's transferor's] title to the stock, or without knowledge sufficient in law to impute notice to him, he would be entitled to the relief prayed, for in such case the corporation would be estopped from denying the recital in its certificate to the effect that the stock was full-paid and nonassessable."⁵³

⁴⁹ 750 A.2d at 532, 536.

⁵⁰ *Id.* at 536-37.

⁵¹ *Id.* at 538-40.

⁵² 115 A. 918, 922 (Del. Ch. 1922) ("It is, therefore, pertinent to now examine the question of whether the complainant, Bowen, was an innocent purchaser from Stover.").

⁵³ *Id.*

Most recently in *MBKS Co. Ltd. v. Reddy*,⁵⁴ the Court of Chancery demonstrated its willingness to look to the “protected purchaser” provisions of the DUCC to validate a stock issuance that may be technically defective under the DGCL.⁵⁵ In *MBKS*, the plaintiff challenged under Section 225 the election of directors by the vote of shares that were alleged to have been defectively issued under the DGCL for invalid consideration.⁵⁶ The Court of Chancery, albeit in *dicta*, stated that when the defective “stock has been transferred to a protected purchaser,” such “[t]hird parties without knowledge of the defect in the stock should be permitted to rely on what appears to be validly issued stock.”⁵⁷ This statement is significant because it is the first (and only) Delaware case applying the “protected purchaser” provisions of the DUCC in the context of stock issued in violation of the DGCL, and provides that although a stock issuance is technically deficient under the DGCL, the stock is valid in the hands of the “protected purchaser.”

The provisions of the DUCC are incorporated into the DGCL by Section 201 of the DGCL, which provides, *inter alia*, that except as otherwise provided in the DGCL, Article 8 of the DUCC governs the transfer of stock and stock certificates that represent stock or uncertificated stock.⁵⁸ The DUCC provides the following rule in situations where the security is claimed to be invalid:

A security other than one issued by a government or governmental subdivision, agency, or instrumentality, even though issued with a defect going to its validity, is valid in the hands of a purchaser for value and without notice of the particular defect unless the defect involves a violation of a constitutional provision. In that

⁵⁴ 924 A.2d 965 (Del. Ch. 2007), *aff'd*, 945 A.2d 1080 (Del. 2008).

⁵⁵ See Bigler and Tillman, *supra* at 1149.

⁵⁶ 924 A.2d at 967.

⁵⁷ *Id.* at 974 and 974 n.30.

⁵⁸ 8 Del. C. § 201.

case, the security is valid in the hands of a purchaser for value and without notice of the defect, other than one who takes by original issue.⁵⁹

The DUCC further provides that “[a]ll other defenses of the issuer of a security . . . are ineffective against a purchaser for value who has taken the certificated security without notice of a particular defense.”⁶⁰ In addition, a “protected purchaser” acquires the rights of a purchaser, as well as “its interest in the security free of any adverse claim.”⁶¹ A “protected purchaser” is defined under the DUCC as “a purchaser of a certificated or uncertificated security, or of an interest therein, who: (1) gives value; (2) does not have notice of any adverse claim to the security; and (3) obtains control of the certificated or uncertificated security.”⁶² “The[se] Code provision[s] [are] operative without regard to whether the security is declared void by the law which creates the requirements which has been violated.”⁶³

A determination that Turnaround is a “protected purchaser” is significant to the outcome of this case. If Turnaround is a “protected purchaser,” then Plaintiffs cannot invalidate Turnaround’s stock. As explained in *MBKS*, stock issued in violation of the DGCL is valid in the hands of a “protected purchaser.”⁶⁴ Thus, the “protected purchaser” provisions of the DUCC

⁵⁹ 6 *Del. C.* § 8-202(b).

⁶⁰ 6 *Del. C.* § 8-202(d).

⁶¹ 6 *Del. C.* § 8-303(b).

⁶² 6 *Del. C.* § 8-303(a).

⁶³ See 8 LARY LAWRENCE, LAWRENCE’S ANDERSON ON THE UNIFORM COMMERCIAL CODE § 8-202:11, at 106 n.20 (3d ed. 1996) (citing Official Comment 4 to Uniform Commercial Code Section 8-202, as read at the time).

⁶⁴ 924 A.2d at 974 and n.30 (citing *Clark v. Airavada Corp.*, 12 F. Supp. 2d 1114, 1117 (D. Nev. 1998) (“A protected purchaser takes stock free of any adverse claim.”)); see also LAWRENCE, *supra* § 8-202:11, at 106 (“As to defects not involving a violation of constitutional provisions, a non-governmental security is valid in favor of an immediate purchaser for value who is without notice of the defect; such a purchaser takes free of *statutory* invalidation . . . as to subsequent purchasers for value who are without notice of the defect, neither *statutory* nor constitutional invalidities may be raised.”) (emphasis added)).

“protect[] a purchaser for value without notice of the defect, irrespective of whether the purchaser took by original issue or subsequently.”⁶⁵

Plaintiffs make three new arguments in light of these positions: (i) “there is no evidence that Delaware Courts are ‘moving away from this rigid rule’ as Turnaround suggests”; (ii) “Turnaround’s argument would ‘gut’ Section 151 of the DGCL and would result in this Court improperly amending Section 151 and Section 201 of the DGCL”; and (iii) a separate ratification “is necessary to make voidable stock validly issued stock” and that has not taken place.⁶⁶ Plaintiffs’ arguments ignore the above discussed cases and that the issue of whether the shares are void or voidable needs to be addressed after the protected purchaser argument is resolved. Shares acquired by Turnaround are valid if it is ultimately determined that Turnaround is a “protected purchaser.” No further action is required to validate those shares.⁶⁷

Plaintiffs’ arguments also continue to ignore the plain language of Section 201.⁶⁸ Nowhere in Section 151 of the DGCL does it state that stock issuances in violation of that statute are null and void. Accordingly, there is no inconsistency in the statutory provisions relating to “protected purchasers” under the DUCC and Section 151 of the DGCL. The only inconsistency

✓ ⁶⁵ See Bigler and Tillman, *supra* at 1146. The DUCC does not clearly apply where one stockholder asserts the invalidity of another stockholder’s purported stock. However, where a corporation is estopped from asserting the invalidity of purported stock, the holder of the stock should be similarly estopped, and so should other holders of corporate securities (whether of that class or of another class or series). *Cf.* 8 *Del. C.* § 124 (limiting those with standing to claim that a corporate act is *ultra vires*). This is a logical conclusion in this case because Plaintiffs seek a declaration from this Court that they are the valid directors of Ameristar and, as a result, they seek to invalidate Turnaround’s shares on behalf of Ameristar.

⁶⁶ Pl. Second Default Mot. at ¶ 19.

✓ ⁶⁷ See LAWRENCE, *supra* § 8-202:10, at 105-06 (“It is to be noted that there is no formal act which ‘validates’ or makes the security valid; the defect or invalidity is merely ignored and the security regarded as valid when the question is raised in the courts.”); Bigler and Tillman, *supra* at 1146 (explaining that no formal action is required “because the stock is deemed valid and this action would accomplish nothing.”).

⁶⁸ 8 *Del. C.* § 201 (“Except as otherwise provided in this chapter, the transfer of stock and the certificates of stock which represent the stock or uncertificated stock shall be governed by Article 8 of subtitle I of Title 6. **To the extent that any provision of this chapter is inconsistent with any provision of subtitle I of Title 6, this chapter shall be controlling.**”) (emphasis added)

is between the “protected purchaser” provisions of the DUCC and the gloss on the case law cited by Plaintiffs.⁶⁹ This hurts Plaintiffs’ position, because the cases cited by Plaintiffs interpreting the DGCL can be superseded or trumped in future cases “by amendment to the DGCL or by *other* on-point statutes” such as the DUCC.⁷⁰

Based on the foregoing analysis, “the policy underlying Article 8 of the DUCC to validate stock in the hands of innocent purchasers for value, notwithstanding technical defects in its issuance, should be recognized as a principle of law” and “should be applied by Delaware courts as such.”⁷¹ “As a result, where stock is held by an innocent third-party purchaser, technical defects relating to statutory formalities should not lead to a finding of void stock.”⁷² A pall could be cast over the purchase of shares in a Delaware corporation were the Court to conclude that a “protected purchaser” who took shares in a Delaware corporation without notice of any defect in the issuance of the stock had no rights in those shares. In the present case, if it is determined that Turnaround is a “protected purchaser,” the stock at issue is valid in the hands of Turnaround, regardless of the defects claimed by Plaintiffs, provided Turnaround is found not have had notice of any defect in the stock.⁷³

⁶⁹ See Bigler and Tillman, *supra* at 1143 n. 203 (explaining that the Delaware case law that stock is “void (for statutory nonconformity) was not expressly controlled by statute rather, it was a judicial gloss on the DGCL . . .”).

⁷⁰ *Id.* (emphasis added); see also *Wilson v. State*, 305 A.2d 312, 317 (Del. 1973) (“Delaware follows the common law except when changed by statute.”); *Toll Bros., Inc. v. Gen. Accident Ins. Co.*, 1999 WL 1442016, at *6 n.4 (Del. Super. Ct. Dec. 27, 1999) (recognizing that case law may be superseded by statute).

⁷¹ See Bigler and Tillman, *supra* at 1111.

⁷² *Id.*; see also *MBKS*, 924 A.2d at 974 (“Third parties without knowledge of the defect in the stock should be permitted to rely on what appears to be validly issued stock.”).

⁷³ See, e.g., *Smouha v. MTA and J.P. Morgan Chase*, 797 N.Y.S.2d 278, 286 (N.Y. Sup. Ct. 2005) (making “protected purchaser” determination on summary judgment motions after discovery); *Dean Witter & Co. v. Educ. Computer Corp.*, 369 F. Supp. 757, 762-64 (E.D. Pa. 1974) (same).