

October 3, 2008

**BRIEF: Noe v. Kropf: Intervenor's Memorandum of Law -- Filed October 3, 2008 -- in the Delaware Court of Chancery citing Bigler & Tillman's Void or Voidable? -- Curing Defects in Stock Issuances Under Delaware Law**

Seth Barrett Tillman

**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

AMERISTAR NETWORK, INC.,

Nominal Defendant.

C.A. No. 4050-CC

**TURNAROUND ADVISORS, LLC'S REPLY BRIEF IN SUPPORT  
OF ITS COMBINED MOTION TO INTERVENE AND  
TO VACATE ORDER TO EXPEDITE PROCEEDINGS**

On September 25, 2008, Turnaround Advisors, LLC ("Turnaround") filed a Combined Motion To Intervene And To Vacate Order To Expedite Proceedings (the "Motion") in this action. Plaintiffs William M. Noe and O. Russell Crandall oppose the Motion in its entirety, and filed their opposition to the Motion on September 29, 2008 (the "Opposition" or "Opp."). In further support of its Motion, Turnaround states as follows:

**INTRODUCTION**

1. In the Motion, as well as in the first-filed lawsuit pending in Utah, Turnaround raises a discrete legal and factual issue. The legal portion of the issue is whether Turnaround is permitted to rely on what appeared to be validly issued stock and take that stock free of all adverse claims as a "protected purchaser" under Article 8 of the Delaware Uniform Commercial

Code (the “DUCC”),<sup>1</sup> notwithstanding the valid composition of the Board of Directors (the “Board”) of Ameristar Networks, Inc. (“Ameristar”) and any defect in the issuance of the Ameristar stock under the Delaware General Corporation Law (the “DGCL”). The factual portion of this issue is whether Turnaround is a “protected purchaser.”

2. Turnaround does not challenge any determination relating to the valid composition of the Ameristar Board. As discovery should reveal, Turnaround would have nothing to add to that determination, other than Turnaround believed that (i) Defendants Robert Kropf, James R. Herbert and Tracy Gnagy were valid directors of Ameristar at the time Turnaround acquired its stock, (ii) Defendants had the authority to issue the stock acquired by Turnaround, and (iii) the stock was issued without any defects.

3. Plaintiffs commence this lawsuit under Sections 225 and 227 of the DGCL. Plaintiffs employ Section 227 of the DGCL to void the Ameristar voting common stock acquired by Turnaround. Plaintiffs employ Section 225 of the DGCL to accomplish this result, because Plaintiffs seek from this Court a declaration that Defendants are not directors of Ameristar and, as a result, all action by Defendants, including the issuance of the Ameristar voting common stock acquired by Turnaround, is void as a matter of law. To the extent Plaintiffs employ either Sections 225 or 227 of the DGCL to void Turnaround’s stock, Turnaround should be permitted to intervene to protect its legitimate interest in that stock. Defendants have not appeared in this action, and there is no other party that can represent Turnaround’s interest. Turnaround’s intervention in this action, however, would be limited to whether Turnaround is a “protected purchaser” under Article 8 of the DUCC.

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<sup>1</sup> Turnaround also claims that it is a “protected purchaser” under Utah Code Ann. § 70A-8-303 (2008), which is virtually identical to the “protected purchaser” provisions under the DUCC.

arguments raised and the authority cited by Plaintiffs ignore Turnaround's rights as a "protected purchaser" under Article 8 of the DUCC.

9. There are a number of Delaware cases discussing the distinction between void stock and voidable stock in the context of a stock issuance defective under the DGCL. See C. Stephen Bigler and Seth Barrett Tillman, *Void or Voidable?—Curing Defects in Stock Issuances Under Delaware Law*, 63 BUS. LAW. 1109 (2008) and cases cited therein. However, 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." See *MBKS Co. Ltd. v. Reddy*, 924 A.2d 965, 972 (Del. Ch. 2007), *aff'd*, 945 A.2d 1080 (Del. 2008). Interestingly, in these cases, except one, the provisions of the DUCC have not been discussed in the context of stock issuances that are technically deficient under the DGCL. See Bigler and Tillman, *supra* at 1111.<sup>4</sup>

10. Delaware law is moving away from the rigid rule articulated by Plaintiffs 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." *Id.* at 1148-49. For example, in *Kalageorgi*, a case cited by Plaintiffs, Delaware courts "demonstrated a willingness to look beyond statutory violations to the equitable result caused by voiding the stock." *Id.* at 1149. *Kalageorgi* was a Section 225 action

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<sup>4</sup> Plaintiffs cite a number of these 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. Opp. at 8. 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).

involving a decision by the Court of Chancery that was affirmed by the Delaware Supreme Court. 750 A.2d at 531. There the plaintiffs held thirty-nine shares, sixty-one shares were issued to the defendants, and 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. *Id.* at 532, 536. 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. *Id.* at 536-37. 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. *Id.* at 538-40. Thus, *Kalageorgi* stands for the proposition that stock issuances defective under the DGCL are not necessarily null and void.

11. Moreover, in *Bowen v. Imperial Theaters, Inc.*, 115 A. 918 (Del. Ch. 1922), another case cited by Plaintiffs, the Court of Chancery recognized the importance of an "innocent purchaser" in a situation where it was alleged that a stock issuance was void. *Id.* at 922 ("It is, therefore, pertinent to now examine the question of whether the complainant, Bowen, was an innocent purchaser from Stover."). 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." *Id.*

12. Most recently in *MBKS*, 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. See Bigler and Tillman, *supra* at 1149. 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. 924 A.2d at 967. 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.” *Id.* at 974 and n. 30. 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.”

13. 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. 8 *Del. C.* § 201. 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 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.

6 *Del. C.* § 8-202(b). 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.” *Id.* at § 8-202(d). In addition, a “protected purchaser” acquires the rights of a purchaser, as well as “its interest in the security free of any adverse claim.” *Id.* at § 8-303(b). 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.” *Id.* at § 8-303(a). “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.” *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).

14. 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.” 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). Thus, the “protected purchaser” provisions of the DUCC “protect[] a purchaser for value without notice of the defect, irrespective of whether the purchaser took by original issue or subsequently.”<sup>5</sup> *See* Bigler and Tillman, *supra* at 1146.

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<sup>5</sup> 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

15. Even accepting as true Plaintiffs' arguments that Plaintiffs (not Defendants) are the valid directors of the Ameristar Board and that the 70,000,000 shares of Ameristar voting common stock were issued in violation of the DGCL, those 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. 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.").

16. Plaintiffs argue that the "protected purchaser" provisions under the DUCC are of no help to Turnaround. Opp. at 11-12. They argue that these provisions are inconsistent with Section 151 of the DGCL and, as a result, the provisions of the DGCL are controlling according to Section 201 of the DGCL. *Id.* In other words, Plaintiffs argue that even if Turnaround is a "protected purchaser," the stock acquired by Turnaround was issued in violation of Section 151 of the DGCL and that statutory provision provides that such a stock issuance is null and void. Plaintiffs' argument is misplaced.

17. Section 201 of the DGCL states:

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.***

8 Del. C. § 202 (emphasis added). 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

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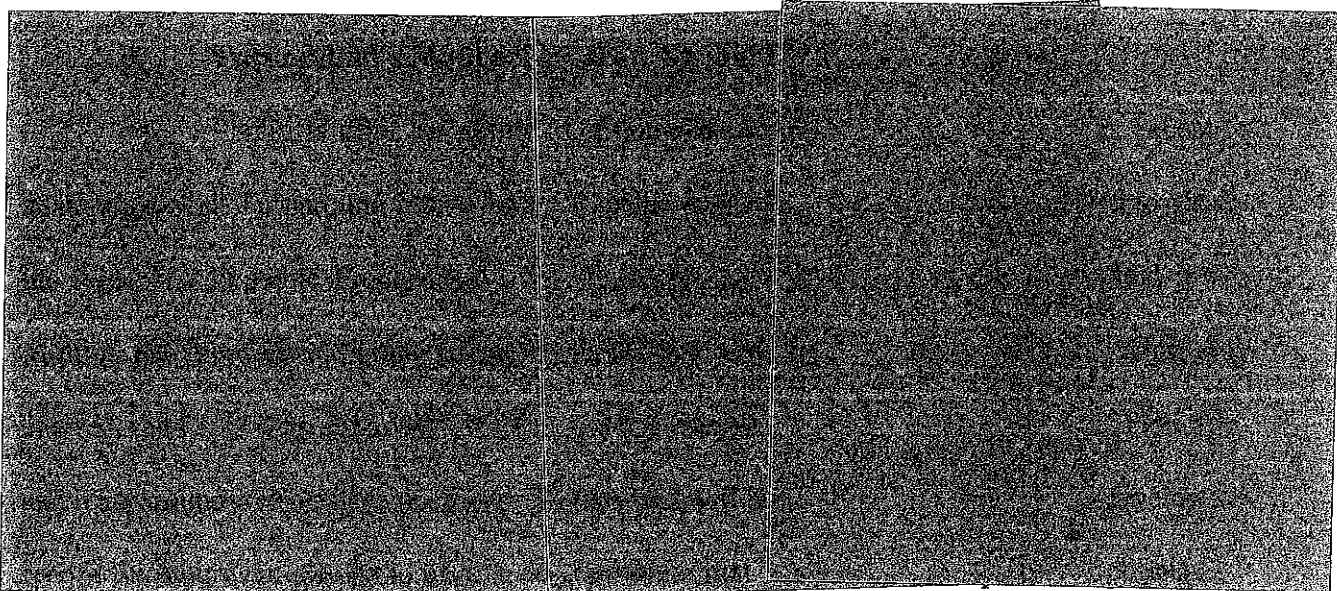
Plaintiffs seek a declaration from this Court that they are the valid directors of Ameristar and, as a result, they seek to invalidate Turnaround's shares on behalf of Ameristar.



the statutory provisions relating to “protected purchasers” under the DUCC and Section 151 of the DGCL. The only inconsistency is between the “protected purchaser” provisions of the DUCC and the gloss on the case law cited by Plaintiffs. 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 . . .”). 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. *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. General Acc. Ins. Co.*, No. 98C-08-203-WTQ, 1999 WL 1442016, at \*6 n. 4 (Del. Super. Ct. Dec. 27, 1999) (recognizing that case law may be superseded by statute).

18. 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.” See Bigler and Tillman, *supra* at 1111. “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.” *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.”). 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. Any

determination into whether Turnaround is a “protected purchaser” should be made with Turnaround’s participation in this action and after adequate discovery has taken place, especially given one of the elements necessary to show Turnaround is a “protected purchaser” requires that Turnaround not have notice of any defect in the stock. *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., Inc. v. Education Computer Corp.*, 369 F. Supp. 757, 762-64 (E.D. Pa. 1974) (same).<sup>6</sup> Accordingly, Turnaround has an interest in this action and should be permitted to intervene because no party to this action adequately represents Turnaround’s interest.



In addition, the Court entered its Order on September 24, 2008. The fact that almost two weeks

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<sup>6</sup> Plaintiffs summarily assert certain “facts” that Turnaround is not a “protected purchaser.” Plaintiffs’ “facts” are inaccurate and, at best, demonstrate the need for discovery into the “protected purchaser” issue. In fact, Plaintiffs concede that the Court need not make any factual determinations on the “protected purchaser” issue to resolve this Motion. Opp. 11-12 (referring to the “protected purchaser” elements and stating that “this Court need not make any of these determinations” in connection with “the Motion.”). Thus, the Court should permit Turnaround to intervene and present facts to this Court establishing that Turnaround is a “protected purchaser” or stay the portion of this action concerning Turnaround’s stock until the Utah court makes a factual determination whether Turnaround is a “protected purchaser.”