Court bars preferred stock class vote that deprived majority of right to elect directors

By Robert S. Reder, Esq., David Schwartz, Esq., and Brian Murphy, Esq.
Milbank, Tweed, Hadley & McCloy

Since the 1988 decision of the Delaware Court of Chancery in *Blasius Industries v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988), Delaware courts have zealously guarded the voting rights of stockholders, demanding that directors demonstrate a "compelling justification" for actions that impact a stockholder vote that "involves an election of directors or touches on matters of corporate control."

Recently, in *Johnston v. Pedersen*, 28 A.3d 1079 (Del. Ch. Sept. 23, 2011), the Chancery Court was asked to decide the outcome of a contested election of directors that hinged on the propriety of a class vote included in the terms of a new series of preferred stock. Applying a *Blasius* analysis, the court concluded that the incumbent directors breached their duty of loyalty by granting a class vote designed to prevent holders of a majority of the outstanding voting power from electing a new board. On this basis, the court took the extraordinary step of stripping the preferred stock of its class vote and installing the insurgent slate of directors.

The court's decision highlights the Delaware courts' continued sensitivity to board actions that affect the stockholder franchise.

BACKGROUND

Xurex Inc. was organized in 2005 as "an early-stage company engaged in the development and sale of protective coatings derived from nano-technology." Xurex's founders raised $10 million of initial financing from outside investors through private placements that resulted in a capital structure of 32 million outstanding shares of common stock and 15 million outstanding shares of Series A preferred stock. The Series A stock carried one vote per share and "voted with the common stock on an as-converted basis."

Following these financings, founders Bo Gimvang, the inventor of the technology, and Bob Bishop, an early CEO, retained majority control over Xurex's outstanding voting power.

TURMOIL AT XUREX

From the outset, Xurex struggled to bring its technology to market. In fact, just one company, DuraSeal Pipe Coatings Co., was able to develop a commercially viable use of Xurex's technology. As Xurex's only customer, DuraSeal accounted for 99 percent of its sales.

By 2009, Xurex stockholders were frustrated with the company's weak performance. Bishop eventually stepped down as CEO in favor of Bill Loven, who was identified by executive recruiter Rex Powers. Once in office, Loven found evidence that Gimvang and Bishop had "defrauded investors and misused company funds." Loven's vigorous pursuit of these claims triggered a series of contests for corporate control.

In the first contest, Gimvang and Bishop used their majority voting power to grant Powers a proxy to remove Loven and the rest of the Xurex board. Powers used this proxy to replace the sitting directors and elect himself, Robert Clifford and Ken Pedersen.

The second contest arose when the new board of directors, in an effort to appease discontented stockholders, "creatively offered to hold an election of directors by written ballot" mailed to stockholders in which any stockholder could nominate candidates. This process resulted in Powers, Pedersen, Clifford, Jay McGarrigle and Dietmar Rose receiving the most votes. Because of concerns about the legitimacy of the mail-in election, however, the Xurex board was simply expanded by the sitting directors to also include McGarrigle and Rose.

Subsequently, Richard Rygg was appointed to fill a vacancy created by the resignation of Rose following a dispute with Powers.

THE SEARCH FOR 'STABILITY'

After the second contest, "the prospect of another election contest loomed like the sword of Damocles" over the Xurex directors. Given that they "intended to pursue … litigation against Bishop to recover misappropriated funds" and were dealing with a "particularly fickle" Gimvang, who could be counted on to revoke the proxy he had previously given to Powers if he believed it in his self interest to do so, the board "understandably expected Bishop and Gimvang to attempt another coup."

Consequently, beginning in March 2010, the directors sought to usher in a period of "stability" — subsequently characterized by the court as "entrenched incumbency" — at the company, "subjectively believ[ing] in good faith that preventing another control dispute would best serve the interests of Xurex and all of its shareholders." To this end, the board notified all stockholders of the opportunity to participate in a $300,000 bridge loan convertible into Series B preferred stock "at a 50 percent discount to the Series B preferred offering price per share."

Pedersen, who met directly with large Xurex stockholders to solicit their participation, learned that these investors likewise "feared another effort by Bishop and Gimvang to take control." As a result, Pedersen began to "selectively disclose[] … to [others] he believed were likely to invest" that the Series B preferred "would include some kind of 'super vote right'" to ward off future control contests.

The initial deadline of April 23, 2010, for participation was twice extended, and other deadlines were waived or ignored "for favored investors," allowing them to

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submit paperwork as late as Sept. 9, 2010. Moreover, directors McGarrigle and Rygg were allowed to subscribe for $50,000 each when the $300,000 offering was not fully subscribed by other stockholders.

In August 2010 the Xurex board utilized the "blank check provision" in the company's certificate of incorporation to "authorize the issuance of up to 20 million shares of Series B preferred."

Like the Series A preferred stock, the Series B preferred stock "carries one vote per share and votes with the common stock on an as-converted basis." Importantly, however, the Series B terms also provided that "so long as 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 class, shall be required for the approval of any matter that is subject to a vote of the [Xurex] stockholders."

Xurex then offered about 8.2 million Series B preferred shares to its stockholders in a private placement that "limited the extent to which stockholders who had not participated in the bridge loan could acquire a substantial position in the Series B preferred." The class vote was not prominently featured in the offering materials. Xurex raised $443,000 in this offering, $269,600 of which "came from converted principal and interest from the bridge loan."

In the court's view, this resulted in the Series B preferred being "successfully placed … with friendly stockholders who are … (i) members of the board, (ii) family or friends of board members, or (iii) belong to investor groups … who support incumbent management."

THE DURASEAL CONSENT SOLICITATION

In mid-2010, DuraSeal's CEO, Joe Johnston, "reached the rather obvious conclusion that it made sense to combine DuraSeal and Xurex." To that end, he reached an agreement to purchase 15 million shares of common stock from Gimvang and obtained an irrevocable proxy to vote all 18.5 million of Gimvang's shares. Johnston also informed two Xurex directors that DuraSeal desired to purchase $1 million of Series B preferred shares. However, "the Xurex board took the position that the Series B offering had closed" and offered DuraSeal only common stock.

In April 2011 DuraSeal began to solicit consents from Xurex stockholders to elect a new board. Overcoming a counter-solicitation by the incumbent board, in June, Johnston delivered written consents purporting to fix the number of directors at five and to elect a new board.

DuraSeal simultaneously filed a lawsuit in the Chancery Court, contending that its written consents represented 69 percent of the outstanding common stock, 51 percent of the outstanding Series A preferred and 13 percent of the outstanding Series B preferred — together, a majority of Xurex's outstanding voting power. The incumbent directors ultimately "conceded that the consents … would be effective [to remove the sitting directors and replace them with DuraSeal's nominees] but for the class vote provision in the Series B preferred."

THE COURT'S ANALYSIS

The court determined initially that the Xurex directors "adopted the class vote provision in the Series B preferred for the specific purpose of preventing holders of a majority of Xurex's common stock and Series A preferred from electing a new board."

On that basis, the court subjected the board's action to an "enhanced scrutiny" test. This test required "that the defendant fiduciaries bear the burden of persuading the court that 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."

Furthermore, because the Series B preferred terms included a class vote affecting "an election of directors" and "touche[d] upon matters of corporate control," the court, applying *Blasius*, required that the Xurex directors provide a "compelling justification" for their actions. Additionally, the court declared that the directors could not justify their action by claiming that "stockholders may vote out of ignorance or mistaken belief about what course of action is in their own interests."

The Xurex directors in turn sought to justify their actions by arguing that "Xurex needed capital and that key investors wanted assurance that … the incumbent board would remain in charge." For the court, this justification "failed to carry [the] burden of persuasion that the class vote provision was adopted in furtherance of a legitimate corporate objective."

In the court's view, the directors "could not act loyally and deprive the stockholders of their right to elect new directors, even though they believed in good faith that they knew what was best for the corporation." Rather, the court explained, the right to elect the Xurex board "belonged to the Xurex stockholders," not to the directors.

The court further declared that even if it were to concede that the board issued the Series B preferred stock "only to raise capital," that goal would not be "a sufficiently compelling justification" for issuing a series of stock with such a potent class vote.

First, the Series B preferred's class vote "was broader than necessary to address investor concerns," as confirmed by the fact that the board gave "a handful of stockholders" negative control over Xurex "for approximately 12.2 percent of [the company's] post-money valuation."

Second, the structure of the bridge loan and Series B offering "was not sufficiently tailored to a capital-raising purpose." Among other things, the compressed time frame to respond to the bridge loan offering, the "absence of detail about the terms of the contemplated Series B preferred" in the offering materials, and the selective disclosure of the "super vote right" to certain "management-supporting stockholders" convinced the court that the capital raise was "structured in a manner nominally open to all stockholders," while "in reality … deliver[ing] control of the class vote into friendly hands."

Thus, even though the court was satisfied that the directors had "acted in good faith," it concluded that the Xurex directors had "breached their duty of loyalty by issuing the Series B preferred." Accordingly, the court ruled that "the Series B preferred are not entitled to a class vote" in connection with the election and declared that DuraSeal's written consents were "effective to remove the defendant directors from office and replace them with new directors."

CONCLUSION

Because the Chancery Court adopted a *Blasius* analysis, it is interesting to note the differences in the underlying facts of these two decisions. In *Blasius*, the proxy contest had already commenced when the

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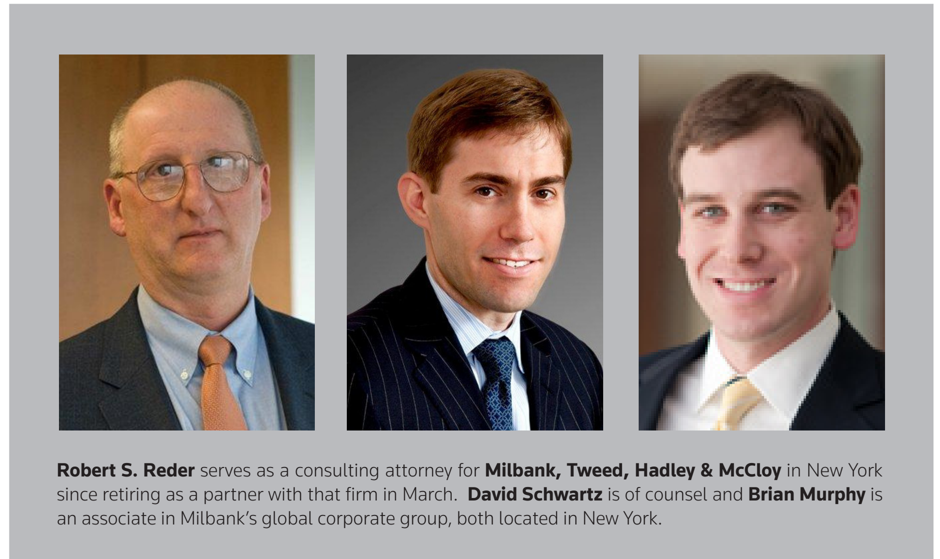
incumbent board acted, and the directors' response was to add two directors to make it mathematically impossible for the insurgents to elect a majority of the 15-member board.

By contrast, in the Xurex case, the incumbent board — in *anticipation* of a proxy contest that had not yet materialized — issued a preferred stock with a class vote to "management-supporting stockholders" to enable them to thwart the election of an opposition slate backed by holders of a majority of the outstanding voting power.

The Chancery Court's decision here highlights the Delaware courts' continued sensitivity to board actions that affect the stockholder franchise. As this ruling and other decisions in the *Blasius* progeny make clear, Delaware courts will not defer to directors' business judgment when their actions "intrude on the space allotted for stockholder decision-making."

Furthermore, if directors impinge upon a stockholder vote involving board elections or corporate control, the directors must offer a "compelling justification" for their decisions — a standard of review the Xurex defendants will no doubt attest is very difficult to satisfy. WJ



Robert S. Reder serves as a consulting attorney for **Milbank, Tweed, Hadley & McCloy** in New York since retiring as a partner with that firm in March. **David Schwartz** is of counsel and **Brian Murphy** is an associate in Milbank's global corporate group, both located in New York.

Breach of duty

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inadequate offer from health insurance giant Cigna Corp.

The board allegedly rubber-stamped the opportunistic offer just before a scheduled announcement of third-quarter profits that would have otherwise sent Healthspring's stock price soaring. Instead, the merger offer effectively capped it at the price of Cigna's $55 bid, the suit says.

Healthspring specializes in offering "Medicare Advantage" plans: privately run versions of the government's Medicare program that offer extras or premiums at prices lower than standard Medicare rates.

Investors were poised to enjoy the benefits of that expansion, but the merger means Cigna will reap the rewards, the suit says.

Healthspring's top officers allegedly will stay on as Cigna's managers of the acquired company.

The directors acted disloyally not only by accepting the inadequate offer but by agreeing to several "deal-protection devices" that will deter competing bidders, the suit says (see box).

The alleged deal-protection devices

- A strict "no solicitation" provision that bars Healthspring from talking to potential bidders.
- A "matching rights" clause that allows Cigna to match or top any competing bid.
- A "termination fee" that requires Healthspring or its acquirer to pay Cigna $115 million if the merger fails.

Investors were poised to enjoy the benefits of that expansion, but the merger means Cigna will reap the rewards, the suit says.

Healthspring, based in Tennessee but incorporated in Delaware, specializes in offering "Medicare Advantage" plans, which are privately run versions of the government's Medicare program that offer extras or premiums at prices lower than standard Medicare rates.

Healthspring recently acquired competitor Bravo Health and can now offer the type of "advantage" plans favored by aging baby boomers in a dozen states, the complaint says.

The suit names as defendants Healthspring CEO Herbert Fritch and eight board members.

Michelson seeks a preliminary injunction against the merger and an order that would force the Healthspring directors to pay for any damages the transaction might cause. WJ

Attorney:
Plaintiffs: Seth Rigrodsky, Rigrodsky & Long, Wilmington, Del.

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