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Delaware Court of Chancery Validates Defective Acts and Clarifies Limited Scope of Dually Direct and Derivative Claims

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In *Almond v. Glenhill Advisors LLC*,[1] the Delaware Court of Chancery provided significant guidance regarding the circumstances under which it would use its equitable powers under Section 205 of the Delaware General Corporation Law (DGCL) to validate acts that, due to technical failures in authorization, would be void or voidable (and thus potentially give rise to claims for rescission or rescissory or other damages). The Court also provided further clarity to the narrow circumstances under which claims for breach of fiduciary duty involving allegations of overpayment could be brought both directly and derivatively.

Background

The dispute in *Glenhill* arose out of Herman Miller, Inc.'s 2014 acquisition of Design Within Reach, Inc. (DWR), an acquisition that amounted to "the culmination of a dramatic turnaround" of DWR. In the aftermath of the financial crisis and the meltdown in the housing market, DWR, a high-end home furnishing retailer, witnessed a severe deterioration in its business. In 2009, funds affiliated with Glenhill invested $15 million in DWR, receiving 92.8 percent of the outstanding equity in exchange for the investment. DWR's business improved following Glenhill's investment, resulting in Herman Miller's $170 million buyout of DWR.

The plaintiffs did not challenge the fairness of the merger, nor did they seek statutory appraisal. Rather, they sought to arrogate to themselves a larger portion of the consideration through a series of technical challenges to the validity of corporate actions taken at DWR in the years leading up to the merger, as well as challenges to transactions between DWR, on the one hand, and some or all of its directors and their affiliates, on the other. As to the technical challenges, the plaintiffs' theory of recovery was based, broadly speaking, on challenges to the validity of a 50-to-1 reverse stock split of DWR's Common Stock and Series A Preferred Stock effected in 2010. Under the terms of DWR's certificate of incorporation, the

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reverse stock split of the Common Stock triggered an adjustment to the conversion ratio of the Series A Preferred Stock, resulting in an automatic reduction in the number of shares of Common Stock into which the Series A Preferred Stock would be convertible. Because this adjustment was overlooked, the Series A Preferred Stock underwent a simultaneous reverse stock split that, when taken together with the automatic adjustment, resulted in a massive (albeit plainly unintended) reduction in the number of shares of Common Stock into which the holders of Series A Preferred Stock could convert. That defect was not uncovered either in 2013, when the Series A Preferred Stock was converted, or in 2014, when the merger became effective.

More than a year after the merger, the plaintiffs, who had by then discovered the defect, amended their compliant to add Herman Miller as a defendant, alleging that the merger, which had been consummated as a "short form" merger under Section 253 of the DGCL, was void due to a failure in its authorization. The essence of plaintiffs' claim was that the shares of Common Stock issued in connection with the 2013 conversion of the Series A Preferred Stock, which did not take into account the inadvertent decrease in the number of shares issuable upon such a conversion, were issued in violation of the terms of the certificate of incorporation. As a result, the plaintiffs argued, Herman Miller did not own the requisite 90 percent of the outstanding Common Stock to effect the merger under Section 253.[2]

In addition to their claims challenging the validity of the merger, the plaintiffs challenged several pre-merger transactions pursuant to which members of DWR's board and their affiliates received equity in DWR. These included a convertible note financing transaction, a grant of restricted stock made to a company owned by one of DWR's directors in connection with restructuring services, and other grants made to certain insiders to account for dilution stemming from other grants. The Court referred to the claims as the "overpayment claims," since each essentially involved an allegation that the directors or their affiliates were unfairly benefitted through the issuance of equity at a discount.

Section 205 Claims

In response to the plaintiffs' amended complaint challenging the validity of the merger, Herman Miller promptly took action under Section 204 of the DGCL to ratify seven distinct defective corporate acts relating to the reverse stock split and the conversion of the Series A Preferred Stock, as well as the merger. Herman Miller also filed a counterclaim under Section 205 of the DGCL to validate those acts. Of those seven acts, the plaintiffs did not challenge (and, indeed, had no interest in challenging) the validation of five. The plaintiffs challenged only those that would preserve their claim to a larger portion of the merger consideration through the invalidation of a massive number of shares of Common Stock issued upon the conversion of the Series A Preferred Stock.

In addressing the parties' respective positions, the Court looked to the factors under Section 205 of the DGCL to determine whether to validate the defective corporate acts. At the outset, the Court indicated that because Sections 204 and 205 of the DGCL were designed to cure inequitable outcomes that would result from technical foot-faults, it was vested with broad remedial powers to cure defective acts.

Among the acts Herman Miller had ratified were the filing and effectiveness of an amendment to the certificate of incorporation to render inoperative the adjustment to the conversion price of the Series A Preferred Stock in connection with the reverse stock split of the Common Stock, given that the simultaneous and equivalent reverse split of the Series A Preferred Stock rendered the need for that provision nugatory. The plaintiffs objected to the validation on the grounds that the defendants had not identified an act capable of being ratified. The Court rejected the argument. The Court recognized that the issuance of shares of Common Stock upon the conversion of the Series A Preferred Stock constituted a corporate act. The Court found that the issuance of

those "excess" shares of Common Stock in violation of the literal terms of the certificate of incorporation constituted a failure of authorization that rendered the issuance defective.

Second, the plaintiffs objected to the validation of an issuance in 2013 of 5,351,439 shares of Common Stock, at a time when there were only 1,600,000 shares of Common Stock authorized for issuance due to the fact that an amendment to DWR's certificate of incorporation increasing the shares of Common Stock to 7,500,000 was not approved until one week after the purported issuance. In this case, the plaintiffs conceded that the overissue constituted a corporate act, but argued that the defendants were not permitted under Section 204 to effectively "backdate" the amendment.[3] The Court again rejected the plaintiffs' argument, noting that even if it were not susceptible to cure through ratification under Section 204, the Court retained the power under Section 205 to validate the act, taking into account the factors set forth in Section 205(d).[4] In each case, the Court found, the factors weighed heavily in favor of validation of the acts ratified under Section 204.

Applying those factors, the Court first found that the challenged actions originally were taken with the belief that they would be effected in compliance with DWR's organizational documents and Delaware law. The Court pointed to, among other things, DWR's reliance on outside counsel to assist with the transactions. Moreover, the Court noted that in light of the massive dilution of the conversion rights of the Series A Preferred Stock resulting from the defects, it was "inconceivable" that any party was aware of the defects at the relevant times. Second, the Court found that DWR had acted at all relevant times in a manner consistent with the belief that the acts were valid. The board's disclosure in both press releases and in filings with the Financial Industry Regulatory Authority (FINRA) supported that conclusion. The Court found that numerous parties, including the plaintiffs, relied on the public record that the acts were valid.

Next, the Court found that no party could credibly claim to be harmed by the ratification of the acts. Although the Court noted that the plaintiffs would lose their claim for damages as a result of the ratification of the acts, that particular harm was not cognizable, as Section 205(d)(3) specifically directs the Court not to consider harms arising from the validation of the act itself. To this point, the Court noted that the

> plaintiffs' selective opposition to validation of the defective corporate acts in the Ratification Resolutions (*i.e.*, not opposing validation of the Reverse Stock Splits but opposing validation of the issuances to preserve the double dilution problem) betray[ed] an intention to obtain a windfall for themselves in this litigation.[5]

The Court then found, by contrast, that various parties, including the defendants, would be harmed by the Court's failure to validate the acts. In this regard, the Court noted that the plaintiffs were seeking an award of damages from the former stockholder-defendants on the basis that they had received an outsized portion of the merger consideration, and that the plaintiffs were seeking an award of damages from Herman Miller on the theory that the merger was "void *ab initio*."[6] In the absence of the validation, each of the parties would face the prospect of paying monetary damages to the plaintiffs solely as a result of technical defects.

Finally, and perhaps most important, the Court found that "ratification [was] clearly the equitable outcome."[7] The defendants, the Court noted, were seeking to "restore the Company and its stockholders to the positions they believed they occupied" at all relevant times.[8] Finding that there was no "inequitable motivation" underlying the failures of authorization at issue, the Court opted to adopt the "'preferred remedy'" of validating the acts.[9] To this end, the Court commented favorably upon Herman Miller's prompt action to remedy the defective acts, using the self-help mechanism available under Section 204 of the DGCL, contrasting it with the plaintiffs' efforts to

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> seek an inequitable windfall for technical defects that DWR, the Board, Glenhill, and Herman Miller had no idea occurred until after the Merger.[10]

Based on the foregoing, the Court validated each of the defective corporate acts and entered judgment in favor of the defendants on each of the plaintiffs' claims related thereto.

Standing to Bring the Overpayment Claims

The Court next addressed the plaintiffs' claims for breach of fiduciary duty relating to the overpayment claims. The Court proceeded from the premise that under the Delaware Supreme Court's opinion in *Lewis v. Anderson*,[11] a plaintiff's standing to maintain a derivative suit is generally extinguished upon a merger, given that a derivative claim is a right owned by the nominal corporate defendant that vests in the acquiring entity in the merger. The plaintiffs did not attempt to argue that the overpayment claims fit into one of the two exceptions to the general rule that a merger extinguishes a derivative claim, but instead advanced a theory of standing on the basis of the "'transactional paradigm'" set forth in the Delaware Supreme Court's opinion in *Gentile v. Rosette*. This case essentially held that a "species of corporate overpayment claim" could be both direct and derivative in nature in circumstances where a controlling stockholder causes the corporation to issue excessive stock to the controller for assets of the controller having lesser value and where the exchange increases the controller's stake and effects a corresponding decrease in the minority's stake.[12]

Before turning to the plaintiffs' specific arguments, the Court reviewed the Delaware Supreme Court's more recent guidance on the holding in *Gentile*. In *El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff*, which involved alleged overpayments to a controlling general partner that were not coupled with a dilution in the minority limited partners' economic interest, the Supreme Court found that it did not satisfy the test articulated in *Gentile* to support the finding that the claims were direct and derivative in nature.[13] Indeed, the *Glenhill* Court noted that the Chief Justice, in his concurring opinion in *El Paso*, questioned the continued viability of *Gentile*'s holding.[14] The *Glenhill* Court stated that, in the wake of *El Paso*, the Chancery Court "has exercised caution in applying the *Gentile* framework."[15]

The Court nevertheless reviewed each of the allegations under the requirements of *Gentile*, ultimately finding that the plaintiffs failed to satisfy them. The Court noted that after Glenhill's 2009 investment in DWR, resulting in its acquisition of more than 92 percent of DWR's equity, Glenhill became the controller, and all of the transactions forming the basis of the overpayment claims occurred after that time. The plaintiffs' *Gentile*-based theory, however, was not based on Glenhill's ownership alone. Due to the fact that Glenhill was not the beneficiary of the overpayment claims, the plaintiffs constructed a theory based on the premise that the individual defendants had formed a control group with Glenhill. The Court, however, declined to find that the individual defendants had formed a control group with Glenhill, pointing to, among other things, the fact that Glenhill did not receive equity or any other form of consideration in connection with certain of the alleged transactions. Indeed, the Court noted that the negotiations with certain of the recipients were vigorous and contested. The Court ultimately found that Glenhill was DWR's sole controlling stockholder from the 2009 restructuring until the merger, and that it did not share its control power with any of the other defendants for purposes of forming a control group and invoking the *Gentile* framework.

Next, the Court found that the overpayment claims did not result in an improper transfer of economic or voting power from the minority stockholders to Glenhill as controller. The Court observed that for purposes of invoking *Gentile*, a transaction would have to disproportionately increase Glenhill's economic and voting power. In this regard, the Court

dispensed with the challenges to the transactions in which Glenhill received no equity securities. With regard to the transactions in which Glenhill received equity securities, such as its 20 percent economic interest in a convertible note and its purchase of 28 percent of the shares issued in a 2012 equity financing, the Court noted that Glenhill's position was in fact diluted. As a result, the plaintiffs were unable to satisfy both prongs of *Gentile*, and judgment was entered in favor of the defendants on each of these claims.

Conclusion

Glenhill is the latest in a series of recent cases in which the Court of Chancery has used its equitable powers to validate past corporate acts believed to have been validly effected but that may have been invalid due to unknown technical defects.[16] The cases indicate that the need for an equitable outcome will often overcome the legal issues implicated by unknown technical defects in Section 205 proceedings and support the judicial validation of corporate acts rendered void or voidable by such defects. The Court's opinion in *Glenhill* also follows recent decisions of the Delaware courts in making clear that the circumstances under which claims may be brought directly and derivatively are exceedingly narrow and limited.

Notes

1. Almond v. Glenhill Advisors LLC, 2018 WL 3954733 (Del. Ch. Aug. 17, 2018).
2. 8 Del. C. § 253.
3. *Glenhill*, 2018 WL 3954733, at *19.
4. 8 *Del. C.* § 205(d).
5. *Glenhill*, 2018 WL 3954733, at *21.
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. Lewis v. Anderson, 477 A.2d 1040, 1049 (Del. 1984).
12. *Glenhill*, 2018 WL 3954733, at *23 (quoting Gentile v. Rosette, 906 A.2d 91, 99–100 (Del. 2006).
13. El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff, 152 A.3d 1248 (Del. 2016)).
14. *Id.* at 1265–66 (Strine, C.J., concurring).
15. *Glenhill,* 2018 WL 3954733, at *24 (citing ACP Master Ltd. v. Sprint Corp., 2017 WL 3421142, at *26 n.206 (Del. Ch. July 21, 2017), *aff'd*, 184 A.3d 1291 (Del. 2018) (TABLE)).
16. *See, e.g.*, Cirillo Family Trust v. Moezinia, 2018 WL 3388398 (Del. Ch. July 11, 2018); CertiSign Hldg., Inc. v. Kulikovsky, 2018 WL 2938311 (June 7, 2018).

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