LEGAL ASPECTS OF CORPORATE FINANCE

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Chapter 1

CORPORATE FINANCE AND THE PROCESS OF CAPITAL FORMATION

§ 1.06 INVESTMENT BANKING

Page 15: Add the following after the quotation from Felix Rohatyn

In other instances, advisory business is utilized by investment banks to obtain financing business. For example, in a so-called "staple loan" scenario, an investment bank representing a selling party in an acquisition transaction will solicit financing business from prospective purchasers; a practice which grew out of the seller's bank literally stapling a financing proposal to a term sheet describing the proposed transaction. Such a practice can give rise to serious conflicts of interest. One example was the subject of *RBC Capital Markets*, *LLC v. Jervis*,[1] where the court found that the seller's investment banking firm purported to conduct final price negotiations with the acquiring party at the same time it was soliciting the latter's financing business. The result was the awarding of nearly $1 billion in damages sustained by the stockholders of the selling corporation. There has also been "a shift in the center of gravity on Wall Street. Increasingly, large corporations are turning to so-called boutique investment banks . . . for advice on deals and strategy. Boutiques are gaining favor for several reasons: They are unburdened by larger trading and financing operations that can create conflicts of interest. Their smaller staffs mean deals have a better chance of staying secret. And increasingly, they are luring the industry's most senior deal makers away from big banks."[2]

[1] 129 A.3d 816, 860-61 (Del. 2015)

[2] David Gelles, *Running With the Big Dogs*, N.Y. Times January 6, 2016 at B1.

§ 1.08 Pertinent Statutory Material

Page 25: Add the following above ARTICLE 5 CORPORATE FINANCE.

§ 202 General powers

(a) Each corporation, subject to any limitations provided in this chapter or any other statute of this state or its certificate of incorporation, shall have power in furtherance of its corporate purposes:

(1) To have perpetual duration.

(2) To sue and be sued in all courts and to participate in actions and proceedings, whether judicial, administrative, arbitrative or otherwise, in like cases as natural persons.

(3) To have a corporate seal, and to alter such seal at pleasure, and to use it by causing it or a facsimile to be affixed or impressed or reproduced in any other manner.

(4) To purchase, receive, take by grant, gift, devise, bequest or otherwise, lease, or otherwise acquire, own, hold, improve, employ, use and otherwise deal in and with, real or personal property, or any interest therein, wherever situated.

(5) To sell, convey, lease, exchange, transfer or otherwise dispose of, or mortgage or pledge, or create a security interest in, all or any of its property, or any interest therein, wherever situated.

(6) To purchase, take, receive, subscribe for, or otherwise acquire, own, hold, vote, employ, sell, lend, lease, exchange, transfer, or otherwise dispose of, mortgage, pledge, use and otherwise deal in and with, bonds and other obligations, shares, or other securities or interests issued by others, whether engaged in similar or different business, governmental, or other activities.

(7) To make contracts, give guarantees and incur liabilities, borrow money at such rates of interest as the corporation may determine, issue its notes, bonds and other obligations, and secure any of its obligations by mortgage or pledge of all or any of its property or any interest therein, wherever situated.

(8) To lend money, invest and reinvest its funds, and take and hold real and personal property as security for the payment of funds so loaned or invested.

(9) To do business, carry on its operations, and have offices and exercise the powers granted by this chapter in any jurisdiction within or without the United States.

(10) To elect or appoint officers, employees and other agents of the corporation, define their duties, fix their compensation and the compensation of directors, and to indemnify corporate personnel.

(11) To adopt, amend or repeal by-laws, including emergency by-laws made pursuant to subdivision seventeen of section twelve of the state defense emergency act, relating

to the business of the corporation, the conduct of its affairs, its rights or powers or the rights or powers of its shareholders, directors or officers.

(12) To make donations, irrespective of corporate benefit, for the public welfare or for community fund, hospital, charitable, educational, scientific, civic or similar purposes, and in time of war or other national emergency in aid thereof.

(13) To pay pensions, establish and carry out pension, profit-sharing, share bonus, share purchase, share option, savings, thrift and other retirement, incentive and benefit plans, trusts and provisions for any or all of its directors, officers and employees.

(14) To purchase, receive, take, or otherwise acquire, own, hold, sell, lend, exchange, transfer or otherwise dispose of, pledge, use and otherwise deal in and with its own shares.

(15) To be a promoter, partner, member, associate or manager of other business enterprises or ventures, or to the extent permitted in any other jurisdiction to be an incorporator of other corporations of any type or kind.

(16) To have and exercise all powers necessary or convenient to effect any or all of the purposes for which the corporation is formed.

(b) No corporation shall do business in New York state under any name, other than that appearing in its certificate of incorporation, without compliance with the filing provisions of section one hundred thirty of the general business law governing the conduct of business under an assumed name.

§ 203. Defense of ultra vires

(a) No act of a corporation and no transfer of real or personal property to or by a corporation, otherwise lawful, shall be invalid by reason of the fact that the corporation was without capacity or power to do such act or to make or receive such transfer, but such lack of capacity or power may be asserted:

(1) In an action by a shareholder against the corporation to enjoin the doing of any act or the transfer of real or personal property by or to the corporation. If the unauthorized act or transfer sought to be enjoined is being, or is to be, performed or made under any contract to which the corporation is a party, the court may, if all of the parties to the contract are parties to the action and if it deems the same to be equitable, set aside and enjoin the performance of such contract, and in so doing may allow to the corporation or to the other parties to the contract, as the case may be, such compensation as may be equitable for the loss or damage sustained by any of them from the action of the court in setting aside and enjoining the performance of such contract; provided that anticipated profits to be derived from the performance of the contract shall not be awarded by the court as a loss or damage sustained.

(2) In an action by or in the right of the corporation to procure a judgment in its favor against an incumbent or former officer or director of the corporation for loss or damage due to his unauthorized act.

(3) In an action or special proceeding by the attorney-general to annul or dissolve the corporation or to enjoin it from the doing of unauthorized business.

Page 81: Add the following after Section 170

§ 204 Ratification of defective corporate acts and stock

(a) Subject to subsection (1) of this section, no defective corporate act or putative stock shall be void or voidable solely as a result of a failure of authorization if ratified as provided in this section or validated by the Court of Chancery in a proceeding brought under § 205 of this title.

(b) (1) In order to ratify 1 or more defective corporate acts pursuant to this section (other than the ratification of an election of the initial board of directors pursuant to paragraph (b)(2) of this section), the board of directors of the corporation shall adopt resolutions stating:

(A) The defective corporate act or acts to be ratified;

(B) The date of each defective corporate act or acts;

(C) If such defective corporate act or acts involved the issuance of shares of putative stock, the number and type of shares of putative stock issued and the date or dates upon which such putative shares were purported to have been issued;

(D) The nature of the failure of authorization in respect of each defective corporate act to be ratified; and

(E) That the board of directors approves the ratification of the defective corporate act or acts.

Such resolutions may also provide that, at any time before the validation effective time in respect of any defective corporate act set forth therein, notwithstanding the approval of the ratification of such defective corporate act by stockholders, the board of directors may abandon the ratification of such defective corporate act without further action of the stockholders. The quorum and voting requirements applicable to the ratification by the board of directors of any defective corporate act shall be the quorum and voting requirements applicable to the type of defective corporate act proposed to be ratified at the time the board adopts the resolutions ratifying the defective corporate act; provided that if the certificate of incorporation or bylaws of the corporation, any plan or agreement to which the corporation was a party or any provision of this title, in each case as in effect as of the time of the defective corporate act, would have required a larger number or portion of directors or of specified directors for a quorum to be present or to approve the defective corporate act, such larger number or portion of such directors or such specified directors shall be required for a quorum to be present or to adopt the resolutions to ratify the defective corporate act, as applicable, except that the presence or approval of any director elected, appointed or nominated by holders of any class or series of which no shares are then outstanding, or by any person that is no longer a stockholder, shall not be required.

(2) In order to ratify a defective corporate act in respect of the election of the initial board of directors of the corporation pursuant to § 108 of this title, a majority of the persons who, at the time the resolutions required by this paragraph (11)(2) of this section are adopted, are exercising the powers of directors under claim and color of an election or appointment as such may adopt resolutions stating:

(A) The name of the person or persons who first took action in the name of the corporation as the initial board of directors of the corporation;

(B) The earlier of the date on which such persons first took such action or were purported to have been elected as the initial board of directors; and

(C) That the ratification of the election of such person or persons as the initial board of directors is approved.

(c) Each defective corporate act ratified pursuant to paragraph (b)(1) of this section shall be submitted to stockholders for approval as provided in subsection (d) of this section, unless:

(1) (A) No other provision of this title, and no provision of the certificate of incorporation or bylaws of the corporation, or of any plan or agreement to which the corporation is a party, would have required stockholder approval of such defective corporate act to be ratified, either at the time of such defective corporate act or at the time the board of directors adopts the resolutions ratifying such defective corporate act pursuant to paragraph (b)(1) of this section; and (B) such defective corporate act did not result from a failure to comply with § 203 of this title; or

(2) As of the record date for determining the stockholders entitled to vote on the ratification of such defective corporate act, there are no shares of valid stock outstanding and entitled to vote thereon, regardless of whether there then exist any shares of putative stock.

(d) If the ratification of a defective corporate act is required to be submitted to stockholders for approval pursuant to subsection (c) of this section, due notice of the time, place, if any, and purpose of the meeting shall be given at least 20 days before the date of the meeting to each holder of valid stock and putative stock, whether voting or nonvoting, at the address of such holder as it appears or most recently appeared, as appropriate, on the records of the corporation. The notice shall also be given to the holders of record of valid stock and putative stock, whether voting or nonvoting, as of the time of the defective corporate act (or, in the case of any defective corporate act that involved the establishment of a record date for notice of or voting at any meeting of stockholders, for action by written consent of stockholders in lieu of a meeting, or for any other purpose, the record date for notice of or voting at such meeting, the record date for action by written consent, or the record date for such other action, as the case may be), other than holders whose identities or addresses cannot be determined from the records of the corporation. The notice shall contain a copy of the resolutions adopted by the board of directors pursuant to paragraph (b)(1) of this section or the information required by paragraph (b)(1)(A) through (E) of this section and a statement that any claim that the defective corporate act or putative stock ratified hereunder is void or voidable due to the failure of authorization, or that

the Court of Chancery should declare in its discretion that a ratification in accordance with this section not be effective or be effective only on certain conditions must be brought within 120 days from the applicable validation effective time. At such meeting, the quorum and voting requirements applicable to ratification of such defective corporate act shall be the quorum and voting requirements applicable to the type of defective corporate act proposed to be ratified at the time of the approval of the ratification, except that:

(1) If the certificate of incorporation or bylaws of the corporation, any plan or agreement to which the corporation was a party or any provision of this title in effect as of the time of the defective corporate act would have required a larger number or portion of stock or of any class or series thereof or of specified stockholders for a quorum to be present or to approve the defective corporate act, the presence or approval of such larger number or portion of stock or of such class or series thereof or of such specified stockholders shall be required for a quorum to be present or to approve the ratification of the defective corporate act, as applicable, except that the presence or approval of shares of any class or series of which no shares are then outstanding, or of any person that is no longer a stockholder, shall not be required;

(2) The approval by stockholders of the ratification of the election of a director shall require the affirmative vote of the majority of shares present at the meeting and entitled to vote on the election of such director, except that if the certificate of incorporation or bylaws of the corporation then in effect or in effect at the time of the defective election require or required a larger number or portion of stock or of any class or series thereof or of specified stockholders to elect such director, the affirmative vote of such larger number or portion of stock or of any class or series thereof or of such specified stockholders shall be required to ratify the election of such director, except that the presence or approval of shares of any class or series of which no shares are then outstanding, or of any person that is no longer a stockholder, shall not be required; and

(3) In the event of a failure of authorization resulting from failure to comply with the provisions of § 203 of this title, the ratification of the defective corporate act shall require the vote set forth in § 203(a)(3) of this title, regardless of whether such vote would have otherwise been required.

Shares of putative stock on the record date for determining stockholders entitled to vote on any matter submitted to stockholders pursuant to subsection (c) of this section (and without giving effect to any ratification that becomes effective after such record date) shall neither be entitled to vote nor counted for quorum purposes in any vote to ratify any defective corporate act.

(e) If a defective corporate act ratified pursuant to this section would have required under any other section of this title the filing of a certificate in accordance with § 103 of this title, then, whether or not a certificate was previously filed in respect of such defective corporate act and in lieu of filing the certificate otherwise required by this title, the corporation shall file a certificate of validation with respect to such defective corporate act in accordance with § 103 of this title. A separate certificate of validation shall be required for each defective corporate act requiring the filing of a certificate of validation under this section, except that (i) 2 or more

defective corporate acts may be included in a single certificate of validation if the corporation filed, or to comply with this title would have filed, a single certificate under another provision of this title to effect such acts, and (ii) 2 or more overissues of shares of any class, classes or series of stock may be included in a single certificate of validation, provided that the increase in the number of authorized shares of each such class or series set forth in the certificate of validation shall be effective as of the date of the first such overissue. The certificate of validation shall set forth:

(1) Each defective corporate act that is the subject of the certificate of validation (including, in the case of any defective corporate act involving the issuance of shares of putative stock, the number and type of shares of putative stock issued and the date or dates upon which such putative shares were purported to have been issued), the date of such defective corporate act, and the nature of the failure of authorization in respect of such defective corporate act;

(2) A statement that such defective corporate act was ratified in accordance with this section, including the date on which the board of directors ratified such defective corporate act and the date, if any, on which the stockholders approved the ratification of such defective corporate act; and

(3) Information required by 1 of the following paragraphs:

a. If a certificate was previously filed under § 103 of this title in respect of such defective corporate act and no changes to such certificate are required to give effect to such defective corporate act in accordance with this section, the certificate of validation shall set forth (x) the name, title and filing date of the certificate previously filed and of any certificate of correction thereto and (y) a statement that a copy of the certificate previously filed, together with any certificate of correction thereto, is attached as an exhibit to the certificate of validation;

b. If a certificate was previously filed under § 103 of this title in respect of the defective corporate act and such certificate requires any change to give effect to the defective corporate act in accordance with this section (including a change to the date and time of the effectiveness of such certificate), the certificate of validation shall set forth (x) the name, title and filing date of the certificate so previously filed and of any certificate of correction thereto, (y) a statement that a certificate containing all of the information required to be included under the applicable section or sections of this title to give effect to the defective corporate act is attached as an exhibit to the certificate of validation, and (z) the date and time that such certificate shall be deemed to have become effective pursuant to this section; or

c. If a certificate was not previously filed under § 103 of this title in respect of the defective corporate act and the defective corporate act ratified pursuant to this section would have required under any other section of this title

the filing of a certificate in accordance with § 103 of this title, the certificate of validation shall set forth (x) a statement that a certificate containing all of the information required to be included under the applicable section or sections of this title to give effect to the defective corporate act is attached as an exhibit to the certificate of validation, and (y) the date and time that such certificate shall be deemed to have become effective pursuant to this section.

A certificate attached to a certificate of validation pursuant to paragraph (e)(3)b. or c. of this section need not be separately executed and acknowledged and need not include any statement required by any other section of this title that such instrument has been approved and adopted in accordance with the provisions of such other section.

(f) From and after the validation effective time, unless otherwise determined in an action brought pursuant to § 205 of this title:

(1) Subject to the last sentence of subsection (d) of this section, each defective corporate act ratified in accordance with this section shall no longer be deemed void or voidable as a result of the failure of authorization described in the resolutions adopted pursuant to subsection (b) of this section and such effect shall be retroactive to the time of the defective corporate act; and

(2) Subject to the last sentence of subsection (d) of this section, each share or fraction of a share of putative stock issued or purportedly issued pursuant to any such defective corporate act shall no longer be deemed void or voidable and shall be deemed to be an identical share or fraction of a share of outstanding stock as of the time it was purportedly issued.

(g) In respect of each defective corporate act ratified by the board of directors pursuant to subsection (b) of this section, prompt notice of the ratification shall be given to all holders of valid stock and putative stock, whether voting or nonvoting, as of the date the board of directors adopts the resolutions approving such defective corporate act, or as of a date within 60 days after such date of adoption, as established by the board of directors, at the address of such holder as it appears or most recently appeared, as appropriate, on the records of the corporation. The notice shall also be given to the holders of record of valid stock and putative stock, whether voting or nonvoting, as of the time of the defective corporate act, other than holders whose identities or addresses cannot be determined from the records of the corporation. The notice shall contain a copy of the resolutions adopted pursuant to subsection (b) of this section or the information specified in paragraphs (b)(1)(A) through (E) or paragraphs (b)(2)(A) through (C) of this section, as applicable, and a statement that any claim that the defective corporate act or putative stock ratified hereunder is void or voidable due to the failure of authorization, or that the Court of Chancery should declare in its discretion that a ratification in accordance with this section not be effective or be effective only on certain conditions must be brought within 120 days from the later of the validation effective time or the time at which the notice required by this subsection is given. Notwithstanding the foregoing, (i) no such notice shall be required if notice of the ratification of the defective corporate act is to be given in accordance with subsection (d) of this section, and (ii) in the case of a corporation that has a class of stock listed on a national securities exchange, the notice required by this subsection and the second sentence

of subsection (d) of this section may be deemed given if disclosed in a document publicly filed by the corporation with the Securities and Exchange Commission pursuant to §§ 13, 14 or 15(d) [15 U.S.C. § 78m, 77n or 78o(d)] of the Securities Exchange Act of 1934, as amended, and the rules and regulations promulgated thereunder, or the corresponding provisions of any subsequent United States federal securities laws, rules or regulations. If any defective corporate act has been approved by stockholders acting pursuant to § 228 of this title, the notice required by this subsection may be included in any notice required to be given pursuant to § 228(e) of this title and, if so given, shall be sent to the stockholders entitled thereto under § 228(e) and to all holders of valid and putative stock to whom notice would be required under this subsection if the defective corporate act had been approved at a meeting other than any stockholder who approved the action by consent in lieu of a meeting pursuant to § 228 of this title or any holder of putative stock who otherwise consented thereto in writing. Solely for purposes of subsection (d) of this section and this subsection, notice to holders of putative stock, and notice to holders of valid stock and putative stock as of the time of the defective corporate act, shall be treated as notice to holders of valid stock for purposes of §§ 222 and 228, 229, 230, 232 and 233 of this title.

(h) As used in this section and in § 205 of this title only, the term:

(1) *"Defective corporate act"* means an overissue, an election or appointment of directors that is void or voidable due to a failure of authorization, or any act or transaction purportedly taken by or on behalf of the corporation that is, and at the time such act or transaction was purportedly taken would have been, within the power of a corporation under subchapter II of this chapter (without regard to the failure of authorization identified in § 204(b)(1)(D) of this title), but is void or voidable due to a failure of authorization;

(2) *"Failure of authorization"* means: (i) the failure to authorize or effect an act or transaction in compliance with (A) the provisions of this title, (B) the certificate of incorporation or bylaws of the corporation, or (C) any plan or agreement to which the corporation is a party or the disclosure set forth in any proxy or consent solicitation statement, if and to the extent such failure would render such act or transaction void or voidable; or (ii) the failure of the board of directors or any officer of the corporation to authorize or approve any act or transaction taken by or on behalf of the corporation that would have required for its due authorization the approval of the board of directors or such officer;

(3) *"Overissue"* means the purported issuance of:

a. Shares of capital stock of a class or series in excess of the number of shares of such class or series the corporation has the power to issue under § 161 of this title at the time of such issuance; or

b. Shares of any class or series of capital stock that is not then authorized for issuance by the certificate of incorporation of the corporation;

(4) *"Putative stock"* means the shares of any class or series of capital stock of the corporation (including shares issued upon exercise of options, rights, warrants or other securities convertible into shares of capital stock of the corporation, or interests with respect thereto that were created or issued pursuant to a defective corporate act) that:

a. But for any failure of authorization, would constitute valid stock; or

b. Cannot be determined by the board of directors to be valid stock;

(5) *"Time of the defective corporate act"* means the date and time the defective corporate act was purported to have been taken;

(6) *"Validation effective time"* with respect to any defective corporate act ratified pursuant to this section means the latest of:

a. The time at which the defective corporate act submitted to the stockholders for approval pursuant to subsection (c) of this section is approved by such stockholders or if no such vote of stockholders is required to approve the ratification of the defective corporate act, the time at which the board of directors adopts the resolutions required by paragraph (b)(1) or (b)(2) of this section;

b. Where no certificate of validation is required to be filed pursuant to subsection (e) of this section, the time, if any, specified by the board of directors in the resolutions adopted pursuant to paragraph (b)(1) or (b)(2) of this section, which time shall not precede the time at which such resolutions are adopted; and

c. The time at which any certificate of validation filed pursuant to subsection (e) of this section shall become effective in accordance with § 103 of this title.

(7) *"Valid stock"* means the shares of any class or series of capital stock of the corporation that have been duly authorized and validly issued in accordance with this title.

In the absence of actual fraud in the transaction, the judgment of the board of directors that shares of stock are valid stock or putative stock shall be conclusive, unless otherwise determined by the Court of Chancery in a proceeding brought pursuant to § 205 of this title.

(i) Ratification under this section or validation under § 205 of this title shall not be deemed to be the exclusive means of ratifying or validating any act or transaction taken by or on behalf of the corporation, including any defective corporate act, or any issuance of stock, including any putative stock, or of adopting or endorsing any act or transaction taken by or in the name of the corporation prior to the commencement of its existence, and the absence or failure of ratification in accordance with either this section or validation under § 205 of this title shall not, of itself, affect the validity or effectiveness of any act or transaction or the issuance of any stock properly ratified under common law or otherwise, nor shall it create a presumption that any such act or transaction is or was a defective corporate act or that such stock is void or voidable.

§ 205 Proceedings regarding validity of defective corporate acts and stock

(a) Subject to subsection (f) of this section, upon application by the corporation, any successor entity to the corporation, any member of the board of directors, any record or beneficial holder of valid stock or putative stock, any record or beneficial holder of valid or

putative stock as of the time of a defective corporate act ratified pursuant to § 204 of this title, or any other person claiming to be substantially and adversely affected by a ratification pursuant to § 204 of this title, the Court of Chancery may:

(1) Determine the validity and effectiveness of any defective corporate act ratified pursuant to § 204 of this title;

(2) Determine the validity and effectiveness of the ratification of any defective corporate act pursuant to § 204 of this title;

(3) Determine the validity and effectiveness of any defective corporate act not ratified or not ratified effectively pursuant to § 204 of this title;

(4) Determine the validity of any corporate act or transaction and any stock, rights or options to acquire stock; and

(5) Modify or waive any of the procedures set forth in § 204 of this title to ratify a defective corporate act.

(b) In connection with an action under this section, the Court of Chancery may:

(1) Declare that a ratification in accordance with and pursuant to § 204 of this title is not effective or shall only be effective at a time or upon conditions established by the Court;

(2) Validate and declare effective any defective corporate act or putative stock and impose conditions upon such validation by the Court;

(3) Require measures to remedy or avoid harm to any person substantially and adversely affected by a ratification pursuant to § 204 of this title or from any order of the Court pursuant to this section, excluding any harm that would have resulted if the defective corporate act had been valid when approved or effectuated;

(4) Order the Secretary of State to accept an instrument for filing with an effective time specified by the Court, which effective time may be prior or subsequent to the time of such order, provided that the filing date of such instrument shall be determined in accordance with § 103(c)(3) of this title;

(5) Approve a stock ledger for the corporation that includes any stock ratified or validated in accordance with this section or with § 204 of this title;

(6) Declare that shares of putative stock are shares of valid stock or require a corporation to issue and deliver shares of valid stock in place of any shares of putative stock;

(7) Order that a meeting of holders of valid stock or putative stock be held and exercise the powers provided to the Court under § 227 of this title with respect to such a meeting;

(8) Declare that a defective corporate act validated by the Court shall be effective as of the time of the defective corporate act or at such other time as the Court shall determine;

(9) Declare that putative stock validated by the Court shall be deemed to be an identical share or fraction of a share of valid stock as of the time originally issued or purportedly issued or at such other time as the Court shall determine; and

(10) Make such other orders regarding such matters as it deems proper under the circumstances.

(c) Service of the application under subsection (a) of this section upon the registered agent of the corporation shall be deemed to be service upon the corporation, and no other party need be joined in order for the Court of Chancery to adjudicate the matter. In an action filed by the corporation, the Court may require notice of the action be provided to other persons specified by the Court and permit such other persons to intervene in the action.

(d) In connection with the resolution of matters pursuant to subsections (a) and (b) of this section, the Court of Chancery may consider the following:

(1) Whether the defective corporate act was originally approved or effectuated with the belief that the approval or effectuation was in compliance with the provisions of this title, the certificate of incorporation or bylaws of the corporation;

(2) Whether the corporation and board of directors has treated the defective corporate act as a valid act or transaction and whether any person has acted in reliance on the public record that such defective corporate act was valid;

(3) Whether any person will be or was harmed by the ratification or validation of the defective corporate act, excluding any harm that would have resulted if the defective corporate act had been valid when approved or effectuated;

(4) Whether any person will be harmed by the failure to ratify or validate the defective corporate act; and

(5) Any other factors or considerations the Court deems just and equitable.

(e) The Court of Chancery is hereby vested with exclusive jurisdiction to hear and determine all actions brought under this section.

(f) Notwithstanding any other provision of this section, no action asserting:

(1) That a defective corporate act or putative stock ratified in accordance with § 204 of this title is void or voidable due to a failure of authorization identified in the resolution adopted in accordance with 204(b) of this title; or

(2) That the Court of Chancery should declare in its discretion that a ratification in accordance with § 204 of this title not be effective or be effective only on certain conditions, may be brought after the expiration of 120 days from the later of the validation effective time and the time notice, if any, that is required to be given pursuant to § 204(g) of this title is given with respect to such ratification, except that this subsection shall not apply to an action asserting that a ratification was not accomplished in accordance with § 204 of this title or to any person to whom notice of the ratification was required to have been given pursuant to § 204(d) or (g) of this title, but to whom such notice was not given.

§ 243 Retirement of stock

(a) A corporation, by resolution of its board of directors, may retire any shares of its capital stock that are issued but are not outstanding.

(b) Whenever any shares of the capital stock of a corporation are retired, they shall resume the status of authorized and unissued shares of the class or series to which they belong unless the certificate of incorporation otherwise provides. If the certificate of incorporation prohibits the reissuance of such shares, or prohibits the reissuance of such shares as a part of a specific series only, a certificate stating that reissuance of the shares (as part of the class or series) is prohibited identifying the shares and reciting their retirement shall be executed, acknowledged and filed and shall become effective in accordance with *§ 103* of this title. When such certificate becomes effective, it shall have the effect of amending the certificate of incorporation so as to reduce accordingly the number of authorized shares of the class or series to which such shares belong or, if such retired shares constitute all of the authorized shares of the class or series to which they belong, of eliminating from the certificate of incorporation all reference to such class or series of stock.

(c) If the capital of the corporation will be reduced by or in connection with the retirement of shares, the reduction of capital shall be effected pursuant to § 244 of this title.

Page 93: Add the following after the end of the text

CERTAIN SECTIONS OF CHAPTER 11 OF THE BANKRUPTCY CODE

§ 362

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities, of--

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning a tax liability of a debtor that is a corporation for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the date of the order for relief under this title.

§ 502

(a) A claim or interest, proof of which is filed under Section 501 of this title, is deemed allowed, unless a party in interest . . . objects.

(b) . . . [I]f such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, *except to the extent that*-

. . . (2) such claim is for unmatured interest;

THE SECURITIES ACT OF 1933

§ 11

(a) Persons possessing cause of action; persons liable

In case *any part* of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person *acquiring* such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue--

(1) every person *who signed* the registration statement;

(2) every person who was *a director* of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) *every underwriter with respect to such security*.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after

the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

(b) Persons exempt from liability upon proof of issues

Notwithstanding the provisions of subsection (a) *no person, other than the issuer*, shall be liable as provided therein *who shall sustain the burden of proof*--

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1) of this subsection, and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (A) as regards any part of the registration statement *not* purporting to be made on the authority of an *expert*, and *not* purporting to be a copy of or extract from a report or valuation of an expert, and *not* purporting to be made on the authority of a public official document or statement, *he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading*; and (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to

make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

(c) Standard of reasonableness

In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

(d) Effective date of registration statement with regard to underwriters

If any person becomes an underwriter with respect to the security after the part of the registration statement with respect to which his liability is asserted has become effective, then for the purposes of paragraph (3) of subsection (b) of this section such part of the registration statement shall be considered as having become effective with respect to such person as of the time when he became an underwriter.

(e) Measure of damages; undertaking for payment of costs

The suit authorized under subsection (a) may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: Provided, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public.

In any suit under this or any other section of this subchapter the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

(f) Joint and several liability; liability of outside director

(1) Except as provided in paragraph (2), all or any one or more of the persons specified in subsection (a) shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

(2) (A) The liability of an outside director under subsection (e) shall be determined in accordance with section 78u-4(f) of this title.

(B) For purposes of this paragraph, the term "outside director" shall have the meaning given such term by rule or regulation of the Commission.

(g) Offering price to public as maximum amount recoverable

In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.

THE NEW YORK GENERAL OBLIGATIONS LAW

§ 13-101

Any claim or demand can be transferred, except in one of the following cases:

1. Where it is to recover damages for a personal injury;

2. Where it is founded upon a grant, which is made void by a statute of the state; or upon a claim to or interest in real property, a grant of which, by the transferrer, would be void by such a statute;

3. Where a transfer thereof is expressly forbidden by: (a) a statute of the state, or (b) a statute of the United States, or (c) would contravene public policy.

§ 13-107

1. Unless expressly reserved in writing, a transfer of any bond shall vest in the transferee all claims or demands of the transferrer, whether or not such claims or demands are known to exist, (a) for damages or rescission against the obligor on such bond, (b) for damages against the trustee or depositary under any indenture under which such bond was issued or

outstanding, and (c) for damages against any guarantor of the obligation of such obligor, trustee or depositary.

2. As used in this section, *"*bond*"* shall mean and include any and all shares and interests in an issue of *bonds, notes, debentures* or other evidences of indebtedness of individuals, partnerships, associations or corporations, whether or not secured.

3. As used in this section, *"indenture"* means any mortgage, deed of trust, trust or other indenture, or similar instrument or agreement (including any supplement or amendment to any of the foregoing), under which bonds as herein defined are issued or outstanding, whether or not any property, real or personal, is, or is to be, pledged, mortgaged, assigned, or conveyed thereunder.

CHAPTER 2

VALUATION OF THE CORPORATE ENTERPRISE AND THE PROCESS OF CAPITAL FORMATION --- PURPOSES AND METHODOLOGY

§ 2.04 APPLICATION OF VALUATION TECHNIQUES; FAIRNESS OPINIONS

Page155: Add the following after the Note

DFC GLOBAL CORPORATION,
v.
MUIRFIELD VALUE PARTNERS, L.P.
172 A.3d 346
Supreme Court of Delaware (2017)

STRINE, J

In this appraisal proceeding involving a publicly traded payday lending firm purchased by a private equity firm, the respondent argues that we should establish, by judicial gloss, a presumption that in certain cases involving arm's-length mergers, the price of the transaction giving rise to appraisal rights is the best estimate of fair value. We decline to engage in that act of creation, which in our view has no basis in the statutory text, which gives the Court of Chancery in the first instance the discretion to "determine the fair value of the shares" by taking into account "all relevant factors."

[Section 262(h) of the Delaware General Corporation Law provides in pertinent part that "the Court shall determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger . . . . In determining such fair value, the Court shall take into account all relevant factors."]

As this Court previously held . . . that language is broad, and until the General Assembly wishes to narrow the prism through which the Court of Chancery looks at appraisal value in specific classes of mergers, this Court must give deference to the Court of Chancery if its determination of fair value has a reasonable basis in the record and in accepted financial principles relevant to determining the value of corporations and their stock.

On the record before us, however, the respondent has made two convincing case-specific arguments why the Court of Chancery's determination of fair value cannot be sustained on appeal. For starters, the respondent notes that the Court of Chancery found that: i) the transaction resulted from a robust market search that lasted approximately two years in which financial and strategic buyers had an open opportunity to buy without inhibition of deal protections; ii) the company was purchased by a third party in an arm's length sale; and iii) there was no hint of self-interest that compromised the market check. Although there is no presumption in favor of the deal price, under the conditions found by the Court of Chancery, economic principles suggest that the best evidence of fair value was the deal price, as it resulted from an open process, informed by robust public information, and easy access to deeper, non-public information, in which many parties with an incentive to make a profit had a chance to bid.

But, despite its own findings about the adequacy of the market check, the Court of Chancery determined it would not give more than one-third weight to the deal price for two reasons.

The first reason was that there were regulatory developments relevant to the company being appraised and, therefore, the market's assessment of the company's value was not as reliable as under ordinary conditions. The respondent argues that this finding was not rationally supported by the record. We agree. The record below shows that the company's stock price often moved over the years, and that those movements were affected by the potential that the company's industry—payday lending and other forms of alternative consumer financial services—would be subject to tighter regulation. The Court of Chancery did not cite, and we are unaware of, any academic or empirical basis to conclude that market players like the many who were focused on this company's value would not have examined the potential for regulatory action and factored it in their assessments of the company's value. Like any factor relevant to a company's future performance, the market's collective judgment of the effect of regulatory risk may turn out to be wrong but established corporate finance theories suggest that the collective judgment of the many is more likely to be accurate than any individual's guess. When the collective judgment involved, as it did here, not just the views of company stockholders, but also those of potential buyers of the entire company and those of the company's debtholders with a self-interest in evaluating the regulatory risks facing the company, there is more, not less, reason to give weight to the market's view of an important factor.

The Court of Chancery also found that it would not give dispositive weight to the deal price because the prevailing buyer was a financial buyer that "focused its attention on achieving a certain internal rate of return and on reaching a deal within its financing constraints, rather than on [the company's] fair value." To be candid, we do not understand the logic of this finding. Any rational purchaser of a business should have a targeted rate of return that justifies the substantial risks and costs of buying a business. That is true for both strategic and financial buyers. It is, of course, natural for all buyers to consider how likely a company's cash flows are to deliver sufficient value to pay back the company's creditors and provide a return on equity that justifies the high costs and risks of an acquisition. But the fact that a financial buyer may demand a certain rate of return on its investment in exchange for undertaking the risk of an acquisition does not mean that the price it is willing to pay is not a meaningful indication of fair value. That is especially true here, where the financial buyer was subjected to a competitive process of bidding, the company tried but was unable to refinance its public debt in the period leading up to the transaction, and the company had its existing debt placed on negative credit watch within one week of the transaction being announced. The "private equity carve out" that the Court of Chancery seemed to recognize, in which the deal price resulting in a transaction won by a private equity buyer is not a reliable indication of fair value, is not one grounded in economic literature or this record. For these reasons, we remand to the Court of Chancery to reconsider the weight it gave to the deal price in its valuation analysis.

The next issue in the respondent's appeal involves the Court of Chancery's discounted cash flow analysis. When the respondent pointed out in a reargument motion that the Chancellor's discounted cash flow model included working capital figures that differed from those the Chancellor expressly adopted in his post-trial opinion, the Chancellor corrected his

clerical error. This would have resulted in the discounted cash flow model yielding a fair value figure lower than the deal price. But, instead of stopping there, at the prompting of the petitioners, the Court of Chancery then substantially increased its perpetuity growth rate from 3.1% to 4.0%, which resulted in the Court of Chancery reaching a fair value akin to its original estimate of the company's value. But, no adequate basis in the record supports this major change in growth rate. During the two decades before the merger leading to this appraisal, the company experienced rapid growth. The growth of the payday lending industry and its effect on poor borrowers during this period was a large driver of the regulatory reforms that the company faced, reforms that would require the company to write more loans to make the same profits as in the past. As it was, the record suggested that the management projections used in the Court of Chancery's original discounted cash flow model were optimistic and designed to encourage bidders to pay a high price. Those projections hockey stick up at the last two years, and therefore more working capital was required to sustain those increases, and that doesn't even account for the likelihood that regulatory changes required more loans (i.e., working capital) to make the same profits as in the past. During the sales process, the company had to revise its aggressive projections downward, as it was not keeping pace with them. Even after revising them downward, the company fell short of meeting them weeks after the transaction closed. Given the nature of the projection's outyears, the fact that the industry had already gone through a period of above-market growth, and the lack of any basis to conclude that the company would sustain high growth beyond the projection period, the record does not sustain the Court of Chancery's decision to substantially increase the company's perpetuity growth rate in its discounted cash flow model after reargument.

On cross-appeal, the petitioners argue that the Court of Chancery abused its discretion by giving weight to its comparable companies analysis, and that the only correct weighting of relevant factors would have given primary, if not sole, weight to the discounted cash flow model. We disagree. The comparable companies analysis used by the Chancellor was supported by the record; this was a rare instance where both experts agreed on the comparable companies the Court of Chancery used and so did several market analysts and others following the company. Thus, giving weight to a comparable companies analysis was within the Chancellor's discretion.

Finally, the Court of Chancery's decision to give one-third weight each to the deal price, the discounted cash flow valuation, and the comparable companies valuation was not explained. Given the Court of Chancery's findings about the robustness of the market check and the substantial public information available about the company, we cannot discern the basis for this allocation. On remand, if the Court of Chancery chooses to use a weighting of different valuation methodologies to reach its fair value determination, the court must explain its weighting in a manner supported by the record before it.

For these reasons, we reverse and remand the Court of Chancery's ruling. On remand, the Chancellor should reassess the weight he chooses to afford various factors potentially relevant to fair value, and he may conclude that his findings regarding the competitive process leading to the transaction, when considered in light of other relevant factors, such as the views of the debt markets regarding the company's expected performance and the failure of the company

to meet its revised projections, suggest that the deal price was the most reliable indication of fair value.

* * * *

Chapter 3

DEBT SECURITIES

§ 3.02 LEGAL AUTHORITY FOR ISSUANCE

Page 158: Add the following after 49 Fordham L. Rev. 277.

In this context, the form a legal opinion takes is a letter prepared and presented in accordance with what is referred to as "customary practice." It generally sets forth the author's opinion as to such matters as the legality of a proposed transaction and the legal efficacy of the transaction documents. It may also deal with factual matters such as the absence of certain litigation. With the consent of the opinion giver's client, the letter is addressed and delivered to another party to the transaction, hence the term third party opinion letter. Although the expression of a legal opinion is not a guarantee of its accuracy, the law requires a third party opinion preparer to exercise that degree of care which an ordinarily prudent lawyer would exercise under the same or similar circumstances. Civil liability to the opinion recipient can attach when there is a failure by the opinion giver to meet that standard. In preparing an opinion letter, a determination is made by the opinion giver as to the establishment of relevant facts and/or the making of necessary assumptions thereof. Also, to the extent necessary, applicable statutes and common law rules and their treatment by the relevant courts are reviewed, as are pertinent articles and treatises. Since "[a] consensus has developed regarding the meaning of language used in third party opinion letters as well as the factual and legal investigation required to support particular opinions,"[3] bar association reports (such as those issued by the TriBar Committee referred to below) dealing with the subject are also often consulted.

Conversely, counsel for an opinion recipient also has duties to the recipient. A 2014 Report by the South Carolina Bar Association states:

> "An opinion recipient has due diligence obligations as well. It should conduct its own investigation of the facts before closing the transaction and should not rely on a closing opinion as a substitute for its due diligence investigation and legal advice from its counsel. Likewise, an opinion recipient's counsel has due diligence obligations to its client. Absent special circumstances where recipient's counsel is rendering a closing opinion and needs to rely on certain opinions of the opinion giver, recipient's counsel is not an appropriate reliance party. Recipient's counsel is unable to avoid professional liability to its client by relying upon the closing opinion."[4]

To the same effect is *Taylor v. Bell,*[5] where the Court stated:

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[3] *Third Party "Closing" Opinions,* A Report of the TriBar Opinion Committee, 53 Bus. Law. 592, 595 (1998).

[4] *South Carolina Third Party Opinion Report* Dec. 2014 at 25 (Footnote omitted.).

[5] 340 P.3d 951, 961 (Wash. Ct. App. 2014) *review denied*, 352 P3d 188 (2015).

> What is clear . . . is that the issuance of the opinion letter could not make the stock purchase transaction legal. And [the opinion recipient] sought out independent counsel to further his goal of legally selling his shares . . . [and] may seek recourse against [the recipient's counsel] as his legal representative.

Page 164: Add the following above § 3.03 DEBENTURE FORM.

The above opinion letter is in fairly standard form, is addressed to Hamon & Hempstead, the fictional underwriter of the public offering of Debentures, and is called for by the Underwriting Agreement referred to in the first paragraph of the opinion. The primary reason for the opinion is to provide the underwriter with the so called "due diligence defense" to a misleading registration statement suit brought against it pursuant to Section 11(a) of the Securities Act of 1933; the defense is accorded an underwriter by Sections 11(b) and 11(c) thereof. (*See* Section 1.08, *supra.*)

The last sentence of paragraph 7 of the opinion letter states only that the standard Underwriting Agreement has been duly executed and delivered, not that it is enforceable in accordance with its terms, among which are those which purport to indemnify the underwriter against, for example, Section 11 liabilities. The reason for that omission is that there is a legal question as to whether such provisions are contrary to public policy and thus unenforceable because an underwriter with such a contractual right might not be as motivated to perform its due diligence function as would otherwise be the case.[6]

The unnumbered paragraph below paragraph 16 is often referred to as the 10b-5 opinion because it tracks the language of Rule 10b-5 under the Securities Exchange Act of 1934. It is also called a negative assurance statement. The paragraph containing it is not numbered because it does not express an opinion instead "it is a statement of belief, unique to securities offerings, based principally on counsel's participation in the process of preparing and discussing the registration statement or other offering document with the various participants in the process." Negative Assurance in Securities Offerings (2008 Revision), 64 *Bus. Law.* 395,397 (2009).

§ 3.03 Debenture Form

Page 166: Add the following at the bottom of the page.

The "full faith and credit clause" provides as follows:

> "Full Faith and Credit shall be given in each State to the public Acts, Records, and Judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof." U.S. Const. art. 4, § 1.

[6] Cf *Globus v. Law Research Serv. Inc.*, *418 F.2d 1276, 1287-90 (2d Cir. 1969)*, *cert. denied*, *397 U.S. 913*.

§ 3.04 [A] Express Covenants.

Page 208: Add the following above [B] Implied Covenants

(2) In *Racepoint,* the New York Court of Appeals also stated that "Plaintiffs which, as *secondary* holders of the notes, are *vested with* the claims and demands of the sellers, then brought this common-law action against Chase alleging, among other things, breach of contract." 14 N.Y.2d at 422 (Emphasis supplied.) Section 13-107 of the New York General Obligations Law provides for the automatic vesting of the seller's claims. (*See* Section 1.08, *supra.*) For example, under New York law a secondary purchaser who acquires bonds at a substantial discount from their principal amount may assert a claim based on the face value thereof.[7] ("The wording of . . . [Section] 13-107 makes it eminently clear that the buyer of a bond receives exactly the same 'claims or demands' as the seller held before the transfer."[8] As the New York Court of Appeals noted, however, prior to its *Bluebird Partners* a federal district court had held that "under the [Trust Indenture Act of 1939], a bond transfer does not carry with it the rights of the transferor (including the right to sue an indenture trustee."[9]

§ 3.05 REDEMPTION PROVISIONS

Page 255: Add the following after Mutual Sav. Life Ins. Co. v. James River Corp.

Wilmington Savings Fund Society, FSB v. Cash America International, Inc.
Southern District of New York
2016 WL 509 2594 (2016)

FURMAN, J.

Roughly three-and-a-half years ago, Defendant Cash America International, Inc. ("Cash America") issued $300 million of notes (the "Notes") pursuant to an indenture agreement (the "Indenture"). In this lawsuit, Plaintiff Wilmington Savings Fund Society, FSB ("Wilmington Savings"), as the trustee for the Noteholders, alleges that Cash America voluntarily breached the Indenture by spinning off a major subsidiary and seeks, in lieu of accelerating the debt, to collect a prepayment premium. Now pending are cross-motions for summary judgment. The relevant facts are undisputed. Instead, the parties' disputes — namely, whether Cash America did, in fact, breach the Indenture and, if so, what remedies are available to the Noteholders — derive from competing interpretations of the Indenture and applicable law. For the reasons that follow, the Court concludes that Wilmington Savings has the better reading of both the parties' contract and of the law, so its motion for summary judgment is GRANTED while Cash America's motion for summary judgment is DENIED.

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[7] See *Bluebird Partners v. First Fidelity Bank,* 97 N.Y.2d 456 (2002).

[8] (97 N.Y.2d at 461.)

[9] (14 N.Y.2d at 460.) *Bluebird Partners, L.P. v. First Fidelity Bank*, 896 F. Supp. 152, (S.D.N.Y. 1995), *aff'd* 85 F. 2d 970, (2nd. Cir. 1996), discussed in Section 3.08[A], *infra*.

Before issuing the Notes, Cash America offered its services through two separate business lines: retail and e-commerce. Enova International ("Enova"), a wholly-owned subsidiary, conducted the e-commerce business — which was substantial. For example, during the first quarter of 2013 (*i.e.*, the last full quarter before Cash America issued the Notes), Enova generated approximately thirty-nine percent of Cash America's revenue.

On May 15, 2013, Cash America completed a private offering of the Notes — specifically, $300 million of 5.75% Senior Notes due 2018 — pursuant to the Indenture naming several of its subsidiaries as guarantors and naming a trustee to represent the Noteholders. Section 5.01 of the Indenture, titled "Consolidation, Merger or Sale of Assets by the Company," prohibits Cash America from engaging in certain transactions. In general, it provides that Cash America "will not, and will not permit any of its Subsidiaries to, dissolve or liquidate or consolidate or merge with, or sell, assign, convey, exchange, lease or otherwise dispose of its properties to, any other Person." (Indenture § 5.01). That restriction, however, is subject to three exceptions, one of which is relevant here: Cash America is permitted to engage in an otherwise prohibited transaction if "the aggregate book value of the properties disposed of . . . does not exceed" ten percent of the company's "Consolidated Total Assets."

The Indenture provides that if Cash America engages in a prohibited transaction (to which no exception applies) it constitutes an "Event of Default" under Section 6.01(3), which allows Wilmington Savings (as trustee for the Noteholders) to pursue a remedy under Sections 6.02 or 6.03. Specifically, absent a bankruptcy, if an Event of Default "occurs and is continuing," Section 6.02 generally permits — but does not require — Wilmington Savings to accelerate the Notes and "declare the principal of and accrued interest on the Notes to be immediately due and payable." And under Section 6.03 — titled "Other Remedies" — Wilmington Savings may pursue "any available remedy by proceeding at law or in equity to collect the payment of principal of and interest on the Notes or to enforce the performance of any provision of the Notes or the Indenture." Finally, to the extent relevant here, the Indenture grants Cash America the option to "redeem" (that is, pay off) the Notes in advance of their due date (thus relieving Cash America of the restrictions contained in the Indenture), but only if the company pays an additional fee — commonly known as a prepayment fee, prepayment premium, or "make-whole" fee.

On April 10, 2014, less than a year after issuing the Notes, Cash America issued a press release announcing that it was reviewing "potential strategic alternatives, including a tax-free spinoff, for the separation of its online lending business that comprises its e-commerce division, Enova International, Inc." In subsequent disclosures, the company revealed that its Board of Directors had approved a "spin-off" of Enova, pursuant to which eighty percent of Enova common stock would be distributed to the Cash America's shareholders and Enova would become "an independent and separate publicly traded company." * * * On November 13, 2014, Cash America effectuated the spin-off by conveying eighty percent of Enova's outstanding shares of common stock to Cash America's shareholders. This suit followed on June 26, 2015.

* * * *

A. Breach

The parties' dispute over whether the Enova spin-off constituted a breach of the Indenture turns on a single question: whether the transaction fell within the scope of the exception to prohibited transactions for transactions in which "the aggregate book value of the properties disposed of . . . does not exceed" ten percent of the company's "Consolidated Total Assets." * * * More specifically, the dispositive question is whether, for purposes of that provision, the "aggregate book value the properties disposed of" is equal to the book value of Enova's assets or equal to the book value of Enova's assets *minus* its liabilities. Wilmington Savings argues it should be calculated by looking at assets alone, in which case the parties agree that the "aggregate book value" of the Enova shares exceeded the relevant threshold by several orders of magnitude and the transaction constituted a breach of the Indenture. By contrast, Cash America contends that the "aggregate book value" of Enova's shares should be calculated by looking at assets minus liabilities, in which case the transaction would fall within the scope of the exception at issue and would not constitute a breach of the Indenture.

Given the unambiguous terms of the Indenture, the Court agrees with Wilmington Savings, and thus concludes that Cash America breached the Indenture. Indeed, that conclusion is compelled by the plain language of Section 5.01(7) of the Indenture, which provides that, "[f]or purposes of determining the book value of property constituting capital stock or similar equity interests of a Subsidiary of the Company disposed of as provided in Section 5.01(2), such book value *shall be deemed to be the aggregate book value of all assets of the Subsidiary* that shall have issued such capital stock or similar equity interests."

* * * *

Cash America's arguments to the contrary are unpersuasive. It argues principally that, as a matter of New York law, the term "book value" always entails subtracting liabilities from assets. Relatedly, it contends that Section 5.10(7) incorporates that meaning of "book value" in deeming equity interest to be equal to "the aggregate book value of all assets of the Subsidiary." In its discussion of New York law, Cash America cites several cases, but none of those cases purports to define "book value" such that, standing on its own, it is "an unambiguous term under New York law. Indeed, several cases involved the language of specific statutes or specific contracts not present here.

* * * *

In fact, it is far from clear what measuring assets minus liabilities could even mean as applied to assets alone. Assets are, well, just assets; unlike companies, they themselves do not have liabilities.

* * * *

Put simply, Cash America seeks to rewrite the contract to say something other than what it says. It follows that the Enova spin-off did not fall within the exception established by Section 5.01(2)(iii), and thus constituted a breach of Section 5.01 and a continuing "Event of Default" within the meaning of Section 6.01(3).

B. Remedy

The Court turns, then, to the question of Wilmington Savings' remedy — specifically, whether the Noteholders may recoup a "make-whole" fee. That question turns on the interplay between the Indenture's prepayment and acceleration clauses. First, Section 3.01 allows Cash America to redeem the Notes in advance of their maturity date by paying a premium, commonly known as a "make-whole" amount. Prepayment clauses are common features of indentures, as "[i]t has long been settled in New York that a borrower does not have a right to prepay an instrument in the absence of a prepayment clause." * * * It is common for them to include a "prepayment fee" or "make-whole" premium, as Section 3.01 does, because the lender had originally "bargained for a stream of income over a fixed period of time." *In re Solutia Inc.*, 379 B.R. 473, 488 (Bankr. S.D.N.Y. 2007). Pursuant to Section 3.01, Cash America could be freed from the Indenture's obligations and restrictions by redeeming the Notes prior to their maturity — *i.e.*, prepaying, with a premium.

Second, Section 6.02 generally permits, but does not require, Wilmington Savings to "accelerate" the maturity of the Notes in the event of a default by Cash America (except if the default is caused by bankruptcy). Such acceleration clauses are, like prepayment clauses, standard provisions of indentures, and New York law governing the interaction between the two is — at least in some respects — well established. In particular, once a debt is accelerated, lenders may not collect a prepayment or make-whole fee (absent provision to the contrary in the indenture, of course). "The rationale for this rule is logical and clear: by accelerating the debt, the lender advances the maturity of the loan and any subsequent payment by definition cannot be a prepayment." *MPM Silicones*, 2014 WL 4436335, at *12; *accord In re LHD Realty Corp.*, 726 F.2d 327, 330-31 (7th Cir. 1984).

Defaults unrelated to bankruptcy appear to be less common, but the Second Circuit confronted one in *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, *691 F.2d 1039 (2d Cir. 1982)*. The dispute in that case concerned debt instruments issued by UV Industries, Inc. ("UV") pursuant to several indentures. Each indenture "contain[ed] clauses permitting redemption by UV prior to the maturity date, in exchange for payment of a fixed redemption price (which includes principal, accrued interest and a redemption premium) and clauses allowing acceleration as a non-exclusive remedy in case of a default." *Id.* at 1042-43. In addition, each indenture "contain[ed] a 'successor obligor' provision allowing UV to assign its debt to a corporate successor which purchases 'all or substantially all' of UV's assets." *Id.* at 1044-45. If, following such a sale or purchase, the debt was not assigned, the indentures required UV to pay off the debt. *Id.* at 1045. In 1979, UV began executing a "predetermined plan of piecemeal liquidation," *id.* at 1049, which concluded with Sharon Steel's purchase of UV's remaining assets and attempt to "formalize its position as [UV's] successor obligor" under the indentures, *id.* at 1046. Litigation ensued; following a directed verdict in the district court, the Second Circuit agreed with the noteholders (and the district court) that the successor obligor clauses did not allow such a maneuver and, thus, that the indentures had been breached. *See id.* at 1047-1053. More significant for present purposes, with respect to whether the noteholders were limited to acceleration as a remedy or could demand the redemption premium, the Second Circuit held that where "acceleration provisions of the indentures are explicitly permissive and

not exclusive of other remedies" and the debtor does not "find[ ] itself unable to make required payments," there is "no bar . . . to [the lender] seeking specific performance of the redemption provisions where the debtor causes the debentures to become due and payable by its voluntary actions." *Id.* at 1053. In such circumstances, "the redemption premium must be paid." *Id.*

The Court agrees with Wilmington Savings that *Sharon Steel* is controlling here. As in *Sharon Steel*, the Indenture has both a redemption clause that requires payment of a make-whole premium as well as an acceleration clause that is "explicitly permissive and not exclusive of other remedies." * * * Thus, Wilmington Savings may seek, pursuant to Section 6.03 of the Indenture, "to enforce the performance of a[ ] provision of the . . . Indenture" — namely, the prepayment provision. In light of the Indenture's permissive, non-exclusive acceleration clause and Cash America's voluntary breach, there is "no bar" to that relief. *Id.* If anything, Wilmington Savings' claim to specific performance is even stronger than the claim of the noteholders in *Sharon Steel*, as the Indenture here expressly grants Wilmington Savings the right to pursue such a remedy. Accordingly, in this case, as in *Sharon Steel*, "the redemption premium must be paid." *Id.*

* * * *

In sum, the Court concludes that, by disposing of eighty percent of the shares of a valuable wholly owned subsidiary, Cash America breached the Indenture. Notably, the transaction disposed of significant property (and for no consideration), reduced Cash America's future expected income, and materially changed its financial condition. As a result, the Noteholders were left holding Notes that, as an economic and legal matter, did not conform to the protections afforded by the Indenture. That constituted a breach of the Indenture and, under the Second Circuit's binding decision in *Sharon Steel*, the Noteholders are entitled to payment of the make-whole premium.

Accordingly, Wilmington Savings' motion for summary judgment is granted and Cash America's motion for summary judgment is denied. * * *

NOTE

The result reached in *Cash America* can be avoided by (assuming the parties agree) adding the following provision to the Indenture:

> For the avoidance of doubt and notwithstanding any to the contrary in the Indenture, the Make-Whole Premium will not be due, or available as a remedy, in connection with (1) any event of default or (2) any acceleration (other than an acceleration in respect of an event of default for failing to pay the redemption price when due following the Company's election to redeem Notes pursuant to the Optional Redemption provisions of the Indenture) whether by reason of a voluntary, involuntary, or automatic acceleration of all or any portion of the Notes.

§ 3.06 "NO ACTION CLAUSES" AND THE INDENTURE TRUSTEE

Page 262: Add the following above Feldbaum v. McCrory Corp.

NOTE

In *Cruden v. Bank of New York*[10] the Court stated: "The district court held that the 'no action' clause applied only to debenture suits against [the issuer], not the Indenture Trustees . . . . This construction of [the Indenture] obviously is correct, as it would be absurd to require the debenture holders to ask the Trustee to sue itself."

Page 265: Add the following above *Rabinowitz v. Kaiser Frazer Corp.*

QUADRANT STRUCTURED PRODUCTS CO. v. VERTIN
New York Court of Appeals
23 N.Y.3d 549, 16 N.E.3d 1165 (2014)

RIVERA, J.

In response to the first certified question from the Supreme Court of the State of Delaware, we conclude that a trust indenture's "no-action" clause that specifically precludes enforcement of contractual claims arising under the indenture, but omits reference to "the Securities," does not bar a securityholder's independent common-law or statutory claims. Accordingly, we answer the second question in the affirmative.

The Delaware litigation underlying the certified questions is a reminder of the continued effects of the 2008 financial crisis and the economic fallout associated with the utilization of complex financial instruments that mask investment risk levels . . . . Against this backdrop of high-stakes securities transactions and downward spiraling financial fortunes, the certified questions present for our consideration familiar efforts to prohibit individual lawsuits of securityholders, by the use of a contractual provision referred to as a "no-action" clause.

Quadrant Structured Products Company, Ltd. (Quadrant) sued several defendants in the Delaware Court of Chancery for alleged wrongdoing related to notes purchased by Quadrant and issued by defendant Athilon Capital Corp. (Athilon), a business which plaintiff alleges is now insolvent. Defendant EBF & Associates, LP (EBF) acquired Athilon in 2010, installed and now controls its Board. Like Quadrant, EBF holds certain Athilon issued securities. Defendants moved to dismiss the suit as barred by a no-action clause contained in the indenture agreement governing Quadrant's notes. The notes and indenture were a necessary part of Athilon's financing scheme, which has its roots in Athilon's initial formation. Athilon was founded in 2004 with $100 million in equity and, along with its wholly owned subsidiary Athilon Asset Acceptance Corp., sold credit derivative products in the form of "credit default swaps" which afforded credit protection for large financial institutions. These credit default swaps provided that Athilon would pay the purchaser in the case of a default on the debt that was the subject of the swap. As a risk containment measure, Athilon's operating guidelines mandated that it invest conservatively, and that when certain "suspension events" occurred, enter "runoff mode"—a

[10] 957 F.2d 961, 968 (2d. Cir. 1992).

period during which it could not issue new credit swaps and was required to pay off existing swaps as claims arose.

As part of its capital raising strategy, Athilon incurred debt through the issuance of a series of securities, as relevant here, consisting of $350 million in senior subordinated notes, $200 million in three series of subordinated notes and $50 million in junior notes. Athilon raised $600 million in capital through this debt structure. Debt subordination is common in commercial finance, and as the name of these different classes of notes implies, payment of senior subordinated notes takes priority over payment of junior notes. Quadrant owns certain classes of these subordinated notes, including senior subordinated notes, while EBF owns junior notes.

As part of this debt financing, Athilon entered agreements, referred to as trust indentures (indentures), with two separate Trustees, who serve as third-party administrators of the issuance of the securities. An indenture is essentially a written agreement that bestows legal title of the securities in a single Trustee to protect the interests of individual investors who may be numerous or unknown to each other . . . . As is typical of these agreements, the Athilon indentures set forth Athilon's obligations as the issuer of the securities, the securityholders' rights and remedies in the case of Athilon's default on the provisions of the indenture, and the duties and obligations of the Trustee. . . .

By 2008, Athilon had undertaken $50 billion in nominal credit default risk, far exceeding its $700 million in capital reserves, which consisted of the $100 million in equity and $600 million in security debt. Quadrant contends that at this rate a mere 0.2% loss on the collateralized debt obligations covered by Athilon's credit default swaps would strip Athilon of its equity and render it insolvent. Indeed, in the aftermath of the 2008 financial crisis, in early 2009, Athilon and its subsidiary sustained several suspension events and entered into runoff mode as per its operating guidelines.

In October 2011, Quadrant sued Athilon, Athilon's officers and directors, EBF, and EBF affiliate Athilon Structured Investment Advisors LLC (ASIA), asserting various counts directly and derivatively as a creditor of Athilon. Quadrant asserted claims for breaches of fiduciary duty, seeking damages and injunctive relief, and also asserted fraudulent transfer claims against EBF and ASIA. According to Quadrant, EBF acquired Athilon in 2010, and controls the Athilon Board by virtue of having installed its board members. Quadrant claimed that the Board failed to preserve Athilon's value in anticipation of liquidation in 2014 when the last credit swap was set to expire, and instead took actions in direct contravention of its duties, but which favored EBF and its affiliate. Specifically, Quadrant alleged that the EBF-controlled Board paid interest on the junior notes, notwithstanding that Athilon agreed to defer interest payments on these notes and that junior notes would not receive a return during liquidation. As a consequence, EBF received payment on its junior notes, to the detriment of senior subordinated securities, including Quadrant's subordinated notes. Quadrant also alleged the Board paid ASIA above-market-rate service fees to manage Athilon's day-to-day operations.

The Court of Chancery characterized Athilon's investment strategy as "high risk" and "contrary to the terms of Athilon's governing documents," which was designed to ensure EBF benefitted financially, regardless of the risk associated with the investment, and regardless of the

status of the EBF junior notes. . . . All the while, the owners of the senior notes suffered the loss of the failed high-risk investment.

Defendants moved to dismiss, asserting that Quadrant's claims were barred by a no-action clause (Athilon clause) contained in article 7, § 7.06 of the indenture governing the subordinated notes. The Athilon clause provides:

> *"Limitations on Suits by Securityholder.* No holder of any Security shall have any right by virtue or by availing of any provision of this Indenture to institute any action or proceeding at law or in equity or in bankruptcy *or otherwise upon or under or with respect to this Indenture*, or for the appointment of a trustee, receiver, liquidator, custodian or other similar official or for any other remedy hereunder, unless such holder previously shall have given to the Trustee written notice of default in respect of the series of Securities held by such Securityholder and of the continuance thereof, as hereinbefore provided, and unless also the holders of not less than 50% of the aggregate principal amount of the relevant series of Securities at the time Outstanding shall have made written request upon the Trustee to institute such action or proceedings in its own name as trustee hereunder and shall have offered to the Trustee such reasonable indemnity as it may require against the costs, expenses and liabilities to be incurred therein or thereby and the Trustee for 60 days after its receipt of such notice, request and offer of indemnity shall have failed to institute any such action or proceedings and no direction inconsistent with such written request shall have been given to the Trustee pursuant to Section 7.08 hereof within such 60 days."

Defendants argued that the clause permitted only Trustee-initiated suits upon request of a majority of securityholders, and prohibited individual securityholder actions. In support of this argument defendants relied on *Feldbaum v. McCrory Corp.* . . . applying New York law, wherein the court dismissed the respective plaintiffs' claims based on a no-action clause. The clauses at issue in [*Feldbaum*] barred a securityholder's action "with respect to this Indenture *or the Securities* unless [specified conditions are met]."

The Delaware Chancery Court dismissed Quadrant's complaint, citing *Feldbaum* . . . On appeal to the Delaware Supreme Court, Quadrant asserted for the first time that the *Feldbaum* clause [was] distinguishable because [it] specifically mentioned claims arising under both the indenture *and* "the Securities," whereas the Athilon clause only applies to claims under the indenture. Therefore, the clause did not bar common-law or statutory claims arising under the securities. The Delaware Supreme Court remanded the case back to the Court of Chancery, ordering it "to issue an opinion analyzing the significance (if any) under New York law of the differences between the no-action clauses in the *Feldbaum* indenture and the Athilon Indenture" . . . .

Thereafter, the Court of Chancery issued a Report on Remand in which the court concluded that the no-action clause applies only to contractual claims arising under the indenture. After a thorough analysis of New York cases and *Feldbaum* . . . , the court found the Athilon clause differed from a *Feldbaum*-type clause, and only extended to actions or

proceedings where a securityholder claims a right by virtue or by availing of any provision of the indenture. The court, therefore, concluded that the majority of Quadrant's claims were not barred under the clause, and that dismissal was warranted with respect to two claims and partial dismissal with respect to a third because only those claims arose under the Athilon indenture.

Upon receipt of the Report, the Delaware Supreme Court certified the following questions to us:

> "(1) A trust indenture no-action clause expressly precludes a security holder[,] who fails to comply with that clause's preconditions, from initiating any action or proceeding upon or under or with respect to 'this Indenture,' but makes no reference to actions or proceedings pertaining to `the Securities.'
>
> "The question is whether, under New York law, the absence of any reference in the no-action clause to the Securities' precludes enforcement only of contractual claims arising under the Indenture, or whether the clause also precludes enforcement of all common law and statutory claims that security holders as a group may have.
>
> "(2) In its Report on Remand . . . , the Court of Chancery found that the Athilon no-action clause, which refers only to 'this Indenture,' precludes enforcement only of contractual claims arising under the Indenture. The question is whether that finding is a correct application of New York law to the Athilon no-action clause" . . . .

Pursuant to section 500.27 of the Rules of Practice of the Court of Appeals (22 NYCRR), we accepted both certified questions . . .

III.

A.

In response to the first question, for the reasons discussed in detail below, we conclude that a no-action clause which by its language applies to rights and remedies under the provisions of the indenture agreement, but makes no mention of individual suits on the securities, does not preclude enforcement of a securityholder's independent common-law or statutory rights. We reach this conclusion based on the legal standards applicable to indenture agreements, as well as the analyses of no-action clauses in *Feldbaum* and *Lange*, and cases from New York.

A trust indenture is a contract, and under New York law "[i]nterpretation of indenture provisions is a matter of basic contract law" (*Sharon Steel Corp. v. Chase Manhattan Bank, NA.*, *691 F.2d 1039, 1049 [2d Cir. 1982]* . . .

In construing a contract we look to its language, for "a written agreement that is complete, clear and unambiguous on its face must be enforced according to the plain meaning of its terms" (*Greenfield v. Philles Records*, *98 N.Y.2d 562, 569 [2002]*. . . . As the case law further establishes, we read a no-action clause to give effect to the precise words and language used, for the clause must be "strictly construed" (*Cruden v. Bank of N.Y.*, *957 F.2d 961, 968 [2d Cir. 1992]* [citation omitted] . . . .

Even where there is ambiguity, if parties to a contract omit terms—particularly, terms that are readily found in other, similar contracts—the inescapable conclusion is that the parties intended the omission. The maxim *expressio unius est exclusio alterius*, as used in the interpretation of contracts, supports precisely this conclusion (*see generally* Glen Banks, New York Contract Law § 10.13 [West's NY Prac. Series 2006]; *see also In re Ore Cargo, Inc.*, 544 F. 2d 80, 82 [2d. Cir. 1976] [where sophisticated drafter omits a term, *expressio unius* precludes the court from implying it from the general language of the agreement]).

Applying these well-established principles of contract interpretation, and with the understanding that no-action clauses are to be construed strictly and thus read narrowly, we turn to the language of the no-action clause presented by the certified question. The no-action clause here states that no securityholder "shall have any right by virtue or by availing of any provision of this Indenture to institute any action or proceeding at law or in equity or in bankruptcy or otherwise upon or under or with respect to this Indenture . . . ." The clear and unambiguous text of this no-action clause, with its specific reference to the indenture, on its face limits the clause to the contract rights recognized by the indenture agreement itself. Further supporting this construction of the clause is the sole textual reference to securities, which is contained in the clause's provision for a Trustee-initiated suit for a continuing "default in respect of the series of Securities. This part of the no-action clause permits the trustee to sue in its name, after notice by a securityholder of a continuing default and upon approval of the suit by a majority of securityholders. Thus, the clear import of the no-action clause is to leave a securityholder free to pursue independent claims involving rights not arising from the indenture agreement.

This no-action clause, with its specific limit on the enforcement of indenture contract rights, is in contrast to no-action clauses which extend beyond the four corners of the indenture agreement to cover securities-based claims. As the cases illustrate, where the no-action clause refers to both the indenture and the securities the securityholder's claims are subject to the terms of the clause, whether those claims be contractual in nature and based on the indenture agreement, or arise from common law and statute.

Thus, in *Feldbaum*, where the no-action clause stated, in pertinent part, that "[a] Securityholder may not pursue *any remedy with respect to this Indenture or the Securities* unless [specified conditions are met]" (1992 WL 119095, *5, 1992 Del. Ch. LEXIS 113, *17, 18 Del. J. Corp. L. at 641), the court held that the clause barred the securityholders' fraud and breach of contract claims against the issuers of the securities (1992 WL 119095 at *2-3, 1992 Del. Ch. LEXIS 113 at *7-10, 18 Del. J. Corp. L. at 636-638). The court concluded that by its language the no-action clause barred not only contractual claims arising from the indenture itself, but also any claims individuals may have based on their status as securityholders (1992 WL 119095 at *7-8, 1992 Del. Ch. LEXIS 113 at *26-27, 18 Del. J. Corp. L. at 645).

* * * *

The decision in *Feldbaum* . . . relied on the language of the clause, which was broad enough to encompass conditions on enforcement of indenture and securities-based claims (*Feldbaum*, 1992 WL 119095 at *6, 1992 Del. Ch. LEXIS 113 at *17-18, 18 Del. J. Corp. L. at 641; . . . . Here, unlike the *Feldbaum* and *Lange* clauses, the Athilon no-action clause omits the

phrase "or the Securities," indicating its coverage is limited to the indenture and rights thereunder.

Decisions from New York further support this interpretation of the words contained in the no-action clause. For example, in *General Inv. Co. v. Interborough R.T. Co.*, *(200 App. Div. 794 [1st Dep't 1922])*, plaintiff sought to recover payment on five promissory notes. Defendant argued the no-action clause barred recovery, relying on language in the clause that provided:

> "No holder of any note hereby secured shall have any right to institute any suit, action or proceeding in equity or at law for the enforcement of this indenture, or for the execution of any trust hereof, or for the appointment of a receiver, or for any other remedy hereunder, unless such holder [meets specified requirements]" (*id.* at 796 [emphasis omitted]).

The Appellate Division held that the no-action clause did not bar plaintiff's suit because the clause applied to proceedings arising from the enforcement of the indenture and plaintiff's action "is not to affect, disturb or prejudice the lien of the collateral indenture or to enforce any right thereunder" (*id.* at 801).

In *Cruden*, plaintiffs sought to assert fraud and civil claims under the Racketeer Influenced and Corrupt Organizations Act (RICO) against the issuer. Defendants argued a no-action clause barred their claims. The clause therein provided:

> "No holder of any Debenture shall have any right by virtue of or by availing himself of any provision of this Indenture to institute any action or proceedings at law or in equity or in bankruptcy or otherwise, upon or under or with respect to this Indenture, or for the appointment of a receiver or trustee, or for any other remedy hereunder . . . ." (1990 WL 131350, *12, 1990 U.S. Dist. LEXIS 11564, *35-36)

Although reversing in part, the Second Circuit agreed with the District Court's conclusion that plaintiffs' fraud and RICO claims were not made under the indenture and, thus, could not be barred by the no-action clause (*Cruden*, 957 F.2d at 968).

* * * *

. . . [A] no-action clause, like the Athilon clause, that refers only to actions under the indenture, is limited by its language to indenture-based contract claims. However, a no-action clause similar to the clause in *Feldbaum* . . . , that refers specifically to claims and remedies arising under the indenture and the securities, applies to all claims, except those excluded from coverage as a matter of law. Here, the Athilon no-action clause when strictly construed and afforded its plain meaning, makes no reference to the securities, and therefore does not apply to claims arising outside the scope of the indenture. Accordingly, we agree with the Delaware Chancery Court's Report on Remand that *Feldbaum* [is] distinguishable, and the Athilon no-action clause applies only to contract claims under the indenture, not to Quadrant's common-law and statutory claims.

Defendants argue that under New York law, what matters is the parties' intent, not any "legal talismans," and that the parties' intent was for the no-action clause to apply to all individual securityholder suits. This is no argument at all, for under our law where the language of the contract is clear we rely on the terms of the document to give effect to the parties' intent . . . . As we have discussed, the no-action clause is clear on its face and applies to indenture contract claims only. The New York cases upon which defendants rely fail to persuade us otherwise, for they involve rights under the indenture, or securityholder rights which a no-action clause may not abridge as a matter of law (*see e.g. Greene v. New York United Hotels, Inc.*, *236 App. Div. 647, 648 [1st Dep't 1932]* [petition for receivership dismissed as defective; debentureholder failed to plead compliance with no-action clause for claims of past-due payment]; *Emmet & Co., Inc. v. Catholic Health E.*, *37 Misc. 3d 854, 856 [Sup. Ct., N.Y. Cnty. 2012]* [claim arising under indenture]; *Walnut Place LLC v. CountrywideHome Loans, Inc.*, *35 Misc. 3d 1207[A], 2012 N.Y. Slip Op 50601[U] [Sup. Ct., N.Y. Cnty. 2012]* [claim against Trustee]). The reasoning in these cases provides no basis to alter our conclusion that a no-action clause that omits language specifically referencing the securities does not extend to a securityholder's common-law and statutory claims.

Nevertheless, defendants argue that, regardless of the actual words used, the language of the no-action clause includes all securityholder actions. Defendants essentially argue that references to the indenture should be interpreted to include the securities, and that to do otherwise will upset the parties' expectations. These arguments are unsupported by the no-action clause itself.

In support of their argument that indenture also means securities, defendants point to the purpose of the no-action clause, which they argue is to prevent unpopular duplicative suits, by channeling all securityholder claims through the Trustee. They contend that a no-action clause prohibits what they call the "lone ranger" lawsuit: individuals asserting claims that foster the interests of minority securityholders at the potential expense of the majority's interest. Quadrant's suit, defendants argue, is exactly the type of litigation the no-action clause is intended to prevent. Given this understanding of the intent of the no-action clause, the omission of the words "the Securities" is logical because they would be superfluous, adding nothing to the already expansive coverage of the clause.

Defendants are correct that generally a no-action clause prevents minority securityholders from pursuing litigation against the issuer, in favor of a single action initiated by a Trustee upon request of a majority of the securityholders (*see* American Bar Foundation, Commentaries on Indentures § 5.7 at 232 [1971] [discussing proposed no-action clause in model indenture, finding "(t)he major purpose of this (proposed no-action clause) is to deter individual debentureholders from bringing independent law suits for unworthy or unjustifiable reasons, causing expense to the Company and diminishing its assets"]).

As the court in *Feldbaum* noted, limitations on individual securityholder suits serve the primary purpose of a no-action clause, which is "to protect issuers from the expense involved in defending [individual] lawsuits that are either frivolous or otherwise not in the economic interest of the corporation and its creditors" (1992 WL 119095 at *6, 1992 Del. Ch. LEXIS 113 at *20,

18 Del. J. Corp. L. at 642). These limitations further "protect[ ] against the risk of strike suits" (*id.*). Indeed, a no-action clause "make[s] it more difficult for individual bondholders to bring suits that are unpopular with their fellow bondholders" (1992 WL 119095, *5, 1992 Del. Ch. LEXIS 113, *19, 18 Del. J. Corp. L. at 642). The no-action clause achieves these goals.

> "by delegating the right to bring a suit enforcing rights of bondholders to the trustee, or to the holders of a substantial amount of bonds, and by delegating to the trustee the right to prosecute such a suit in the first instance. These clauses also ensure that the proceeds of any litigation actually prosecuted will be shared ratably by all bondholders" (1992 WL 119095 at *6, 1992 Del. Ch. LEXIS 113 at *21, 18 Del. J. Corp. L. at 643 [citation omitted]).

However, even defendants admit that the Athilon clause is not a complete bar to any and all securityholder suits. There are claims which, by law, cannot be prohibited by a no-action clause, most notably claims against the trustee (*see e.g.*, 15 U.S.C. § 77000[d] ["The indenture . . . shall not contain any provisions relieving the indenture trustee from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct"]; *see also Cruden*, *957 F.2d at 968* [no-action clause will not bar securityholder suit against Trustee because "it would be absurd to require the debenture holders to ask the Trustee to sue itself"]).

Defendants appear to argue that the enactment of the Trust Indenture Act of 1939 (TIA) eliminated the need to reference the securities in a no-action clause because the TIA prohibits the clause from barring a securityholder's action against the Trustee for breach of duties recognized by the TIA, or for past-due interest or principal on the securities (*see* 15 U.S.C. § 77ppp[b]). Of course, as Quadrant's case illustrates, a securityholder may have claims apart from claims against the Trustee, or for past-due payments. Moreover, as long as the indenture does not violate or conflict with the TIA, the parties may structure the indenture agreement to address their respective interests and obligations, including placing limits on certain claims of right.

Most significant here is that the no-action clause, by its own terms, is concerned with minority holders' actions in the case of a default by the issuer of the securities. The no-action clause requires a written request for the Trustee to commence an action or proceeding *regarding a default* with respect to the series of securities held by the noteholder and approval by a majority of securityholders. Logically then, the no-action clause applies when the Trustee is authorized to decide whether to act; it cannot serve as an outright prohibition on a suit filed by a securityholder in the case where the Trustee is without authorization to act. Otherwise, the purpose of the no-action clause—to avoid duplicative suits and protect the majority interests by mandating that actions be channeled through the Trustee—would be subverted (*Feldbaum*, 1992 WL 119095 at *6, 1992 Del. Ch. LEXIS 113 at *19, 18 Del. J. Corp. L. at 642). This is what the parties intended. Of course, they were free to not limit the no-action clause in this way. Here, therefore, the purpose of the Athilon no-action clause is not frustrated where the Trustee is without authority to act.

Defendants' argument that interpreting the no-action clause to exclude certain claims would upset the contracting parties' expectations is unpersuasive. The indenture itself defines "indenture" and "securities" separately, recognizing them as distinct. Therefore, defendants'

functional equivalency argument is merely another version of the argument we have already rejected on the law: that the parties intended other than what the words in the document mean. As our law makes clear, we rely on the unambiguous terms of the agreement when construing contract provisions like the indenture no-action clause . . . . Quadrant's claims are based not on the indenture agreement—under which the Trustee administers the debt issuance by Athilon—but rather arise from Quadrant's status as a securityholder. The parties could not have expected otherwise, given the plain language of the clause. If the parties sought to prohibit these types of suits, they were free to include them within the Athilon no-action clause.

We also note that in 2000, the Ad Hoc Committee for Revision of the 1983 Model Simplified Indenture produced a model no-action clause which provides "[a] Securityholder may pursue a remedy with respect to this Indenture or the Securities only if [the holder complies with the terms of the clause]" (55 Bus. L. 1115, 1137-1138 [2000]). By its terms, the no-action clause references the indenture and the securities. Even this broad model clause is not without limits. In its commentary to this provision, the Committee states: "[t]he clause applies, however, only to suits brought to enforce contract rights under the Indenture or the Securities, not to suits asserting rights arising under other laws" (*id.* at 1191). The Committee intended the model no-action clause to limit only contract rights, not to encompass all securityholder suits. We express no opinion on whether no-action clauses should be so narrowly construed, but note only that parties sophisticated and well versed in this area of the law—like the parties here—are well aware of these commentaries and, thus, we find unsupportable defendants' argument that a construction of the no-action clause that permits Quadrant's claims to proceed would be unsettling to the parties' expectations.

B.

The second certified question asks whether the Vice Chancellor's Report on Remand correctly interpreted New York law. We answer this question in the affirmative. In its complaint, Quadrant asserts individual and derivative claims seeking damages and injunctive relief for breaches of fiduciary duty, fraudulent transfer, breach of covenant of good faith and fair dealing, intentional interference with contractual relations, and conspiracy. Essentially, Quadrant claims that Athilon's Board, installed and controlled by EBF, acted pursuant to a scheme which ensures that the junior securityholders are paid, despite their inferior status vis-à-vis Quadrant's senior notes, and, as a consequence, payment of the junior securities imperils payment of the senior securities. As described by Quadrant, Athilon's actions are an effort to siphon off as much capital as possible, as quickly as possible, for the benefit of EBF. Thus understood, the Trustee cannot address these claims because the Trustee's duties, as per the indenture, are only triggered upon an event of default—exactly what Quadrant seeks to avoid, at least with respect to the senior securities.

Accordingly, the Vice Chancellor correctly concluded that, with the exception of two claims and part of a third, the no-action clause did not bar plaintiff's action. The claims the Vice Chancellor found viable are those that the Trustee cannot assert, as they are not based on any default on the securities. Specifically, the Vice Chancellor correctly found that those claims

sounding in breach of contract and arising from the indenture are barred—requiring the majority securityholders to bring those actions through the Trustee.

IV.

Accordingly, the certified questions should be answered in accordance with this opinion.

§ 3.08[A]

Insert the following after William O. Douglas, Go East Young Man 260 (1983)

In 1936 the Securities and Exchange Commission issued a Report[11] based on Douglas' work which concluded that one of the reasons for the losses sustained by such investors was that the terms of indentures pursuant to which their debt securities had been issued failed to provide them with sufficient contractual protection. Those indentures usually contain a number of undertakings by the issuer intended to enhance the probability of its being able to make principal and interest payments on the underlying debt instrument. Indentures also designate a trustee and provide remedies in the event of the issuer's breach of the indenture:

> "As the modern concept of debentures developed . . . the indenture designate[d] a corporate trustee to protect the rights of the many holders of the debentures and to perform certain ministerial tasks connected with the normal operations of the debentures. Thus, although the *debts* created by the debentures run directly from the issuer to the holders, the *contractual rights* conferred by the indenture run from the issuer to the trustees for the benefit of the holders of the debentures."[12].

The SEC Indenture Report also found that:

> "upon the public distribution of the bonds, debentures or notes, secured by an indenture, the name of a prominent institution which will act as trustee is eagerly sought. The addition of the name of such an institution to the prospectus is not without advertising value to the distribution. Likewise it is not without significance to the prospective investors. Persons are undoubtedly influenced to purchase securities by the size, prestige and financial strength of the trustee."[13]

The principal problem revealed by the SEC Indenture Report, however, was that although trust indentures often granted broad protective powers to the trustee, those same

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[11] *Functions of Protective and Reorganization Committees, Part VI Trustees under Indentures* (1936) (hereinafter cited as the "SEC Indenture Report"). That Report was recently exhumed from the musty past and quoted and cited extensively in the landmark *Marblegate* litigation discussed Section 3.08[D]*infra.* It was also closely analyzed in *CNH Diversified Opportunities Master Account LLP v. Cleveland Unlimited, Inc.,* 36 N.Y.3d 1 (2020), § 3.08 [D], *infra*. Consequently, it warrants more extensive treatment than in previous editions hereof.

[12] *Broad* v. *Rockwell Int'l Corp*., 642 F.2d 929, 941 (5th Cir.1981.) (Footnote omitted; emphasis supplied.)

[13] *Id.*; as one prominent New York jurist observed in a pre-Trust Indenture Act opinion the "purchasers of bonds must have been influenced by the fact that the trustee was a huge institution like Chase National Bank." *Hazzard v. Chase Nat'l Bank*, *159 Misc. 57, 74 (Sup. Ct. 1936)*, (Rosenman, J.) *aff'd* 257 App. Div. 950, (1st Dep't1939), *aff'd* 282 N.Y. 652, *cert. denied*, 311 U.S. 708 (1940).

indentures contained broad exculpatory and responsibility limiting provisions which in effect relegated the so-called indenture trustee to a mere "clerical agency".[14] This was attributable to the fact that the terms of those Indentures were negotiated and approved by the prospective issuer of the debt securities, the underwriters responsible for distributing the securities to the public and the indenture trustee. Absent from the negotiation table was anyone acting on behalf of the prospective investors. Moreover, a number of courts routinely enforced the indentures' broad, exculpatory provisions as written, and thus declined to find that debt holders were entitled to the protection usually afforded to trust beneficiaries by trustees having df fiduciary duties of due care and loyalty.

The carefully crafted opinion of New York Supreme Court Justice Samuel Rosenman in *Hazzard* v. *Chase National Bank*[15] is often cited as a leading example of this jurisprudence.[16] In discussing the state of the law prior to the Trust Indenture Act, Justice Rosenman stated:

> "In such indentures the use of the word 'trustee 'is clearly a misnomer. The corporate trustee has very little in common with the ordinary trustee, as we generally understand the fiduciary relationship. The ordinary trustee is supposed to represent the interests of the beneficiary alone. The courts impose upon him an undivided loyalty to the *cestui que trust*. So strict is the rule of undivided loyalty to the beneficiary that the mere fact that a trustee has an interest inconsistent with the interest of his *cestui*, casts upon him the burdens of explanation and justification . . . . The trustee under a corporate indenture, on the other hand, has his rights and duties defined, not by the fiduciary relationship, but exclusively by the terms of the agreement. His status is more that of a stakeholder than one of a trustees. Indeed in the earlier indentures the documents were rather in the form of escrow agreements and no duties were assigned to the trustee. . . . Far from refraining from occupying inconsistent positions, corporate trustees have affirmatively and deliberately assumed them to an increasing degree. Corporate trustees have come to act as promoters, underwriters, bankers, financial advisers, bondholders and creditors of companies whose debenture holders they have been selected to protect . . ."[17]

In that case the Indenture permitted the bond obligor to withdraw common stocks which had been pledged to secure the payment of the bonds, and substitute shares of other corporations. The Trustee permitted such a substitution; and in a short time the newly deposited securities became worthless, as did the bonds themselves. The Court found that the Indenture in *Hazzard*:

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[14] SEC Indenture Report at 4.

[15] Justice Rosenman has been described as "one of New York's ablest judges." H.C. McCollom, The Securities and Exchange Commission and Corporate Trustees, 36 *Colum. L. Rev.* 1197, 1201 (1936). He was an advisor to President Franklin D. Roosevelt. See, e.g., Samuel I. Rosenman *Working With Roosevelt* (1952).

[16] The *Hazzard* decision was not without its critics. *See* George E. Palmer, Trusteeship Under The Trust Indenture Act, 41 *Colum. L. Rev.* 193, 205-06 (1941).

[17] 1159 Misc. at 83-84. (Citations omitted.)

> "was particularly vicious. It permitted the substitution of practically all the collateral, on the bare statement of officers of the obligor as to earnings. It made unnecessary any check-up by an impartial agency. It rendered unnecessary any consideration on the part of the so-called trustee to the comparative value and soundness of the substituted collateral .It placed in the hands of the obligor the power to wipe out completely the security behind the debentures."[18]

The Indenture also provided that Chase "would not be liable for any act, default, neglect, or misconduct, absent a showing of gross negligence or bad faith."[19]

In the light of such decisions as *Hazzard*, the SEC Indenture Report determined that:

> "The basic problem is to refashion the trust indenture for the purpose of according greater protection to investors. That entails prescribing certain minimum standard specifications for the conduct of trustee and issuer thereunder. As in the case of other contracts involving persons not capable nor in a position to protect themselves, the contents of the trust indenture can no longer be left to the conventions of the issuer, the trustee or the underwriter."
>
> "This means that a more proper balance between the interests of investors and requirements of issuers can be had only by enlarging the definition of the trustees' duties in those cases where its failure to take swift and positive action leaves the investors without effective protection of their interests. The contrary desire of issuer, trustee and underwriter must be made to bow to the insistent demands of investors and of the public interest in such cases."[20]

The manner selected by Congress to accomplish that objective was a unique, indirect, form of regulation. The Trust Indenture Act of 1939 dealt with the problem by in effect writing the parties' indenture for them. Certain indenture terms were prohibited; others were made mandatory and still others were designated optional. For example, Section 315(d) *prohibited* (with certain exceptions) the inclusion of terms relieving an indenture trustee from civil liability for negligence or willful misconduct; Section 315 (c) *required* that, an indenture provide that, *in the event of* a default, a trustee exercise the same degree as a prudent person would exercise under the same circumstances; and Section 315 (a) *permitted* an indenture to provide that, *prior to* default, the indenture trustee shall only be liable for the performance of duties that are specifically set forth in the indenture.

The reforms were thus built into the Indenture itself and were thus contractual in nature. As Douglas testified during the Congressional deliberations on the Act:

> After the indenture has once been qualified, the Commission, under this bill, cannot step in and issue a stop order against the further sale of securities issued

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[18] 159 Misc. at 84.

[19] Charles E. Dropkin. Implied Liability Under The Trust Indenture Act: Trends And Prospects, 52 *Tulane L. Rev.* 299, 302 (1978) (hereinafter cited as *Dropkin*).

[20] SEC Indenture Report at 6.

> thereunder. After it has been qualified, the indenture becomes a contract. Thereafter it is enforceable only by the bondholders, the trustee and the obligor.[21]

To underscore the private remedy approach taken by the Trust Indenture Act, Douglas added "the Indenture, after it has been qualified under this statute, will be enforceable, in the same manor that indentures are enforceable."[22]

> "As Commissioner Douglas testified [in support of the passage of the Trust indenture Act]: 'The indenture, after it has been 'qualified' under this statute, will be enforceable, *in the same manner as any other contract is enforceable, in the same manner that indentures presently executed are enforceable.'* An indenture is nothing more than a private contract and should be treated as such. Since ordinary contract disputes are resolved in state courts under state law, so also should indenture disputes continue to be settled."[23]

The import of Commissioner Douglas' statement is borne out by the unique draftsmanship of the Act. Only one provision, apart from section 322, contains the word "liability," and in that section the proscribed activity concerns not the violation of indenture provisions, but the making of misleading statements in any application, report, or document filed with the Commission and relating to the indenture.

As one federal court has observed:

> the legislative history suggests that Congress considered the existing body of common law sufficient to protect investors, as long as the trustee was precluded

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[21] *Dropkin* 307.

[22] *Id.* at 323. In 1938 indentures were enforced in contract actions brought in state courts. "An indenture is nothing more than a private contract and should be treated as such. Since ordinary contract disputes are resolved in state courts under state law, so also should indenture disputes continue to be settled." *Id*.

[23] *Dropkin* 323. (Emphasis in original; footnotes omitted.) In the light of the Trust Indenture Act's legislative history, it is difficult to imagine how the Third Circuit could have stated "It is hard to believe that Congress would have established uniform standards to govern indentures and then paradoxically have allowed the application of those standards to depend on the law of the state of the suit. The interpretation of the indenture provisions mandated by the Act does not depend on ordinary contract principles—the intent of the parties—but depends on an interpretation of the legislation. It would be contrary to the purposes of the Act to have the trustee held to certain standards in one state court and potentially different standards in another." *Zeffiro v. First Pennsylvania Banking & Trust Co*., 623 F. 290, 299 3d Cir. 19880, *cert denied*, 456 U.S. 1005 (1982). This appears to be inconsistent with the testimony of Justice Douglas discussed above, which establishes that enforcement of TIA indentures by (i) federal courts is to be based upon the application of post *Erie* state common law principles of contract construction (*Eire Ry. v. Tompkins*, 304 U.S. 64 [1938] abolished federal common law in diversity cases and instead required application of the substantive state law of the forum) and (ii) state courts exercising their concurrent subject matter jurisdiction and applying their own contract law principles. The Court seemed to overlook this point when it said "applying state law would mean that this federal statute could be interpreted differently in all 50 states." It is not a federal *statute* which is being interpreted, instead *contract* provisions are being construed; this is true even with the passage of the 1990 amendments.

> from contractually limiting the duties it imposed upon fiduciaries, and so long as he explicitly assumed particular duties.[24]

Accordingly, in keeping with the Act's manner of private enforcement in breach of contract suits, private actions for breach of Trust Indenture Act mandated indenture provisions may be brought in state or federal courts:

> "Of course since the jurisdiction section of the Securities Act [of 1933] referred to in [Section 322(b) of the Trust Indenture Act], grants the district courts *concurrent jurisdiction* over suits at law and equity to enforce any liability created by the statute, 15 U.S.C. s77v(a), the state courts may also interpret those terms in qualified indenture agreements"[25]

Fifty years after the effective date of the Trust Indenture Act, the Trust Indenture Trust Indenture Reform Act of 1990[26] (the "Trust Indenture Reform Act") became law. Among its stated purposes were "removing the administrative burden from the SEC [and] reducing legal and printing costs"[27] as well as "eliminating twenty to thirty pages of boilerplate indenture provisions for each qualified indenture."[28] As the SEC observed in its 1987 Memorandum proposing the Trust Indenture Reform Act:

> "[t]he Act as amended will make inclusion of mandatory indenture terms self-executing through operation of law, a change that will provide greater assurance that such provisions are part of every qualified indenture and remove substantial administrative burdens from the Commission's staff and from persons subject to the Act.[29]

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[24] *Morris v. Cantor*, 390 F. Supp. 817, 822 (S.D.N.Y. 1975).

[25] 390 F. Supp. at 822n.5. (Emphasis supplied.) For examples of Trust Indenture Act and enforcement by state courts, see, e.g., *Quadrant Structured Prods. Co*. v. *Vertin*, 23 N.Y.3d 549, 566 (2014), *Racepoint Partners LLC v. JP Morgan Chase Bank*, N.A,, 14 N.Y.3d 419 (2010), *AG Capital Funding Partners,L.P. v. State Street Bank & Trust Co.,*11 .N.Y. 3d 146, 157-58 (2008). *United States Trust Co. v. First Nat'al Bank, 57* App. Div. 2d 285, 292 (1st Dep't 1977); Springwell Navigation Corp. v. Sanluis Corp.; 206 WL 3742803 *6 (N.Y. Sup. Ct. 2006; Schallitz *v. Starrett Corp*., 82 N.Y.S.2d 89, 91 (N.Y. Sup. Ct. 1948). In addition, since many privately placed debt securities are issued pursuant to indentures that incorporate the provisions of the Trust Indenture Act, state courts are called upon to interpret those provisions. *See, e.g.*, *CNH Diversified Opportunities Master Account, L.P. v. Cleveland Unlimited, Inc.*, 36 N.Y. 3d 1N.Y.3d 1 (2020).

[26] Trust Indenture Act of 1990, Pub. L. No. 101-550, Tit. IV, 104 Stat. 2721.

[27] Michael Vincent Campbell, Implications Of The Trust Indenture Reform Act of 1990 Breathing New Life Into The Trust Indenture Act Of 1939. 11 Am Rev. Banking L. 181 (1992). Other purposes of the Reform Act included removing certain restrictions on indenture trustees, simplifying indenture qualification requirements "and encouraging internalization of the securities markets." *Id.*

[28] *Id.* at 22.

[29] Trust Indenture Reform Act of 1987 [1987-88 Transfer Binder] Fed. Sec. L. (CCH para 84,205 at 921.

To accomplish those objectives, for example, the *permissive* provisions of Section 315 (a) of the TIA set forth above were amended to read as follows:

The indenture to be qualified shall automatically be deemed (unless it is expressly provided therein that any such provision is excluded) to provide that, prior to default . . .

(1) The indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture . . . .

The *mandatory* provisions of Section 315 (c) were amended to state that:

The indenture trustee shall exercise in case of default . . . such of the rights and powers vested in it by such indenture, and to (sic?) use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.

In point of fact, the Trust Indenture Reform Act turned out to have been a solution in search of a problem. It appears to be rarely used, and to this day, nearly all trust indentures continue to physically include within their four corners the Trust Indenture Act's permissive and mandatory provisions. In order to facilitate staff TIA compliance review of trust indentures (most of which, notwithstanding the Reform Act, continue to contain provisions mandated by the TIA), Section 229.601(b)(4)(iv) of SEC Regulation S-K[30] continues to require that each indenture subject to the Act contain a cross reference sheet indicating where in the mandatory and permitted provisions are located in the indenture."

Under the Trust Indenture Reform Act the "statutory inserts" continue to be terms set forth in the trust indenture contract. Thus, Section 318 (c) provides that:

"The provisions of Sections 310 to and including 317 that impose duties on any person (including provisions automatically deemed included in an indenture unless the indenture provides that such provisions are excluded) *are a part of and govern* every qualified indenture, *whether or not physically contained therein*, shall be deemed retroactively to govern each indenture heretofore qualified, and prospectively to govern each indenture hereafter qualified under this title . . . ."[31]

As stated by the SEC:

"Moreover, new section 318 (c) would automatically incorporate those statutorily prescribed duties into every qualified indenture. This would preserve debt holders' *right to sue for breach of contract*, as well as their federal right of action for indenture terms required by the Act, which is clarified by the amendments to section 322, the Act's jurisdictional provision."[32]

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[30] 17 C.F.R. § 229.601(b)(4) (2014).

[31] (Emphasis supplied.)

[32] *Ibid*, at 88,929. (Emphasis supplied.)

It is thus apparent that law suits, whether state or federal, seeking to enforce trust indenture provisions continue to be breach of contract actions to which applicable state substantive law applies.

With regard to such litigation, Section 322(b) of the Trust Indenture Act incorporates by reference Section 322 (a) of the Securities Act of 1933 which gives state courts concurrent jurisdiction over claims thereunder and also *"prohibits removal to the federal courts of any action brought under the statute in any state court of competent jurisdiction."*[33] As a result a plaintiff suing under the Trust Indenture Act have *"an exclusive choice of forum."*[34]

The above described legislative history calls into question the holding of *Bluebird Partners, L.P. v. First Fidelity Bank*[35] referred to in Section 3.04 of this Chapter in which the Court refused to apply the automatic assignment provision set forth in Section 13-107 of the New York General Obligations Law to an action against an indenture trustee for breach of its duties under Section 315(c) of the Trust Indenture Act even though the Indenture provided that New York law was to govern its interpretation,[36] stating we do not have to interpret the Indenture (and thus apply New York law) to decide whether a federal claim under the Act is automatically assigned to a subsequent purchaser."[37] In reaching that result, the Court relied on *In re Nucorp Energy Securities Litigation*[38] a case arising under Section 323(a), the only anti-fraud Section of the Trust Indenture Act,[39] rather than a breach of contract action seeking to enforce a qualified indenture provision.[40] The *Bluebird* Court characterized the Trust Indenture Act as *"part of the large and complicated body of law covering securities transactions"*[41] and adopted *Nucorp's* reasoning that, like federal securities claims generally, a Trust Indenture Act anti-fraud claim is

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[33] III Louis Loss, Securities Regulation 2006 (2nd Ed. 1961).

[34] See Henry M. Hart, Jr. & Herbert Wechsler, *The Federal Courts and the Federal System* 732 (1953).

[35] 85 F.3d 970 (2nd Cir. 1996).

[36] 85 F.3d at 974.

[37] Id.

[38] 772 F.2d 776 (9th Cir. 1985).

[39] "Unlike other securities statutes whose focus is on disclosure of material information as a means of investor protection, the 1939 Act departs from this formula by requiring the application of specific terms in the indenture to be qualified thereunder." Michael Vincent Campbell Implications of the Trust Indenture Reform Act of 1990 Breathing New Life Into the Trust Indenture Act of 1939, *11 Am. Rev. Banking L.* 181, 184 (1992) (Footnotes omitted).

[40] The *Nucorp* Court itself emphasized the anti-fraud nature of the plaintiff's Trust Indenture Act claim: "[t]he statute provides nothing for subsequent purchasers to whom no misrepresentations were made directly or indirectly and to whom no statutorily provided cause of action was expressly assigned." 772 F.2d 1490 (Emphasis supplied).

[41] 772 F.2d at 1489

not one which "runs with the ownership of a security . . ."[42] It appears, however, that the anti-fraud *Nucorp* case is inapposite to *Bluebird* because the latter was an action for breach of a New Yok contract, claiming a violation a Trust Indenture Act mandated indenture provision.

Among the elements of state law applicable to *Bluebird* was Section 13-107 of the New York General Obligations Law, Section 1.08*, supra* which provides for automatic assignment of claims by bondholders for breach of an indenture provision.

§ 3.08[C] Requirements of and Form of Compliance with Section 315 of the Trust Indenture Act

Page 285: Add the following at the bottom of the page.

SEC. 318 (a) If any provision of the indenture to be qualified limits, qualifies, or conflicts with the duties imposed by operation of subsection (c) of this section, the imposed duties shall control.

(b) The indenture to be qualified may contain, in addition to provisions specifically authorized under this subchapter to be included therein, any other provisions the inclusion of which is not in contravention of any provision of this subchapter.

(c) *The provisions of Sections 310 to and including 317* that impose duties on any person (including provisions automatically deemed included in an indenture unless the indenture provides that such provisions are excluded) *are a part of* and govern every qualified indenture, *whether or not physically contained therein*, shall be deemed retroactively to govern each indenture heretofore qualified, and prospectively to govern each indenture hereafter qualified under this subchapter and shall be deemed retroactively to amend and supersede inconsistent provisions in each such indenture heretofore qualified. The foregoing provisions of this subsection shall not be deemed to effect the inclusion (by retroactive amendment or otherwise) in the text of any indenture heretofore qualified of any of the optional provisions contemplated by Section 310(b)(i), 311(b), 314(d), 315(a), 315(b), 315(d), 315(e), or 316(a)(1).

[D] ACCELERATION PROVISIONS AND SECTION 316 OF THE TRUST INDENTURE ACT – [CHANGE TO SECTION 316 OF THE TRUST INDENTURE ACT OF 1939]

Page 299: Add the following immediately before the beginning of Section [E]

Marblegate Asset Management, LLC v. Education Management Finance Corp.
US Court of Appeals, Second Circuit.
846 F.3d 1 (2017)

Following corporation's out-of-court restructuring of its debt through intercompany sale of assets foreclosed by secured creditors and release of guarantee of unsecured notes, non-consenting noteholders brought action under Trust Indenture Act (TIA) seeking declaratory relief. Corporation counterclaimed seeking declaratory relief permitting it to remove guarantee.

[42] 772 F.2d at 1489.

After a bench trial, the United States District Court for the Southern District of New York, Failla, J., 111 F.Supp. 3d 542, ruled that the restructuring violated the Trust Indenture Act and ordered continuation of guarantee and payment in full to non-consenting noteholders. Corporation appealed.

LOHIER, J

Defendant-appellant Education Management Corporation ("EDMC") and its subsidiaries appeal from a judgment following a bench trial before the United States District Court for the Southern District of New York. The District Court held that a series of transactions meant to restructure EDMC's debt over the objections of certain noteholders violated Section 316(b) of the Trust Indenture Act of 1939, 15 U.S.C. § 77ppp(b). The transactions at issue, the District Court determined, stripped the non-consenting noteholders, plaintiffs-appellees Marblegate Asset Management, LLC and Marblegate Special Opportunity Master Fund, L.P. (together, "Marblegate"), of their practical ability to collect payment on notes purchased from EDMC's subsidiaries. As a result, the District Court ordered EDMC to continue to guarantee Marblegate's notes and pay them in full.

* * * *

EDMC is a for-profit higher education company that relies heavily on federal funding through Title IV of the Higher Education Act of 1965. EDMC is the parent company of defendants-appellants Education Management, LLC and Education Management Finance Corporation (together, the "EDM Issuer").

In 2014 EDMC found itself in severe financial distress. Its enterprise value had fallen well below its $1.5 billion in outstanding debt. But restructuring its debt by resorting to bankruptcy court was not a realistic option for EDMC, which, the parties agree, would lose its eligibility for Title IV funds if it filed for bankruptcy and discontinued as an ongoing concern. EDMC therefore had to cooperate with its creditors outside of the bankruptcy process if it hoped to restructure its debt and persist as a viable entity.

EDMC's outstanding debt consisted of both secured debt (roughly $1.3 billion) and unsecured debt ($217 million). The secured debt was governed by a 2010 credit agreement between the EDM Issuer and secured creditors (the "2010 Credit Agreement"). The 2010 Credit Agreement gave EDMC's secured creditors the right, upon default, to deal with the collateral securing the loans "fully and completely" as the "absolute owner" for "all purposes." The collateral securing the debt consisted of virtually all of EDMC's assets.

The unsecured debt, to which we will refer as the "Notes," was also issued by the EDM Issuer and governed by an indenture executed in March 2013 and qualified under the Trust Indenture Act of 1939 (the "Indenture"). The Notes were guaranteed by EDMC as the parent company of the EDM Issuer (we refer to this guarantee as the "Notes Parent Guarantee") and carried a high effective interest rate—nearly 20 percent per year—to compensate for the riskier nature of the unsecured debt. Both the Indenture and the offering circular relating to the Notes informed lenders who had purchased them (the "Noteholders") about their rights and obligations as junior, unsecured creditors. For example, the offering circular explained that the Notes Parent

Guarantee was issued solely to satisfy EDMC's reporting obligations, that it could be released solely by operation of the release of any later guarantee EDMC issued to secured creditors, and that Noteholders should therefore not assign any value to the Notes Parent Guarantee. Marblegate holds Notes with a face value of $14 million but never held any secured debt.

As EDMC's financial position deteriorated, its debt burden became unsustainable. After negotiating with EDMC, a majority of secured creditors agreed in September 2014 to relieve the EDM Issuer of certain imminent payment obligations and covenants under the 2010 Credit Agreement. The resulting agreement was a new amended credit agreement entered in the fall of 2014 (the "2014 Credit Agreement"). As consideration for these changes, EDMC agreed to guarantee the secured loans (the "Secured Parent Guarantee").

Around the same time, a group of creditors formed an Ad Hoc Committee of Term Loan Lenders (the "Ad Hoc Committee") and established a Steering Committee, which is an intervenor-appellant in this appeal, to negotiate with EDMC. The Steering Committee and EDMC eventually devised two potential avenues to relieve EDMC of its debt obligations.

The first option, which obtained only if creditors unanimously consented, was designed to result in (1) most of EDMC's outstanding secured debt being exchanged for $400 million in new secured term loans and new stock convertible into roughly 77 percent of EDMC's common stock, and (2) the Notes being exchanged for equity worth roughly 19 percent of EDMC's common stock. EDMC estimated that this first option would amount to roughly a 45 percent reduction in value for secured lenders and a 67 percent reduction in value for Noteholders.

The second option would arise only if one or more creditors refused to consent. Under that circumstance, a number of events would occur that together constituted the "Intercompany Sale." Secured creditors consenting to the Intercompany Sale would first exercise their preexisting rights under the 2014 Credit Agreement and Article 9 of the Uniform Commercial Code (UCC) to foreclose on EDMC's assets. In addition, the secured creditors would release EDMC from the Secured Parent Guarantee. That release in turn would effect a release of the Notes Parent Guarantee under the Indenture. With the consent of the secured creditors (but without needing the consent of the unsecured creditors), the collateral agent would then sell the foreclosed assets to a subsidiary of EDMC newly constituted for purposes of the Intercompany Sale. Finally, the new EDMC subsidiary would distribute debt and equity only to <u>consenting</u> creditors and continue the business.

The Intercompany Sale was structured to incentivize creditors to consent. While non-consenting secured creditors would still receive debt in the new EDMC subsidiary, that debt would be junior to the debt of consenting secured creditors. Non-consenting Noteholders would not receive anything from the new company: though not a single term of the Indenture was altered and Noteholders therefore retained a contractual right to collect payments due under the Notes, the foreclosure would transform the EDM Issuer into an empty shell. In offering to exchange the Notes for equity in the new EDMC subsidiary, therefore, EDMC and the Ad Hoc Committee explicitly warned Noteholders that they would not receive payment if they did not consent to the Intercompany Sale.

Except for Marblegate, all of EDMC's creditors (representing 98 percent of its debt) eventually consented to the Intercompany Sale.

* * * *

Marblegate, the sole holdout, sued to enjoin the Intercompany Sale on the ground that it violated Section 316(b) of the Trust Indenture Act of 1939 (the "TIA"). Section 316(b) of the TIA, entitled "Prohibition of impairment of holder's right to payment," provides as follows:

> Notwithstanding any other provision of the indenture to be qualified, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder, except as to a postponement of an interest payment consented to as provided in paragraph (2) of subsection (a) of this section, and except that such indenture may contain provisions limiting or denying the right of any such holder to institute any such suit, if and to the extent that the institution or prosecution thereof or the entry of judgment therein would, under applicable law, result in the surrender, impairment, waiver, or loss of the lien of such indenture upon any property subject to such lien.

* * * *

Before the District Court, EDMC argued that "the right . . . to receive payment" is necessarily defined by the payment terms in the Indenture itself, such that Section 316(b) prohibits only non-consensual amendments to an indenture's core payment terms. Therefore, EDMC asserted, the Intercompany Sale complied with Section 316(b) because it did not amend any Indenture term and because Marblegate's right to initiate suit against the EDM Issuer to collect payment remained intact.

In response, Marblegate contended that although the contractual terms governing Marblegate's Notes had not changed, its *practical ability to receive payment* (*emphasis added) would be completely eliminated by virtue of the Intercompany Sale, to which it did not consent. Section 316(b), Marblegate warned, would be rendered meaningless if issuers and secured creditors could collaborate to restructure debt without formally amending any payment terms.

The core disagreement in this case is whether the phrase "right . . . to receive payment" forecloses more than formal amendments to payment terms that eliminate the right to sue for payment.

* * *Marblegate's broad reading of the term "right" as including the practical ability to collect payment leads to both improbable results and interpretive problems. Among other things, interpreting "impaired or affected" to mean any <u>possible</u> effect would transform a single provision of the TIA into a broad prohibition on any conduct that could influence the value of a note or a bondholder's practical ability to collect payment. * * *The right to receive payment, it seems to us, prohibits non-consensual amendments of core payment terms (that is, the amount of

principal and interest owed, and the date of maturity). It bars, for example, so-called "collective-action clauses"—indenture provisions that authorize a majority of bondholders to approve changes to payment terms and force those changes on all bondholders. *See NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 246, 253 (2d Cir. 2012). The latter right (to sue) ensures that individual bondholders can freely sue to collect payments owed under the indenture. So construed, the right to sue clearly bars so-called "no-action clauses," which preclude individual bondholders from suing the issuer for breaches of the indenture, leaving the indenture trustee as the sole initiator of suit. *See Cruden v. Bank of New York*, 957 F.2d 961, 967–68 (2d Cir. 1992). An indenture that contains only a collective-action clause violates the "payment" right, not the "suit" right; an indenture that contains only a no-action clause violates the "suit" right, not the "payment" right.

Because the text of Section 316(b) is ambiguous and the TIA's structure fails to remove the ambiguity, we turn to legislative history.

Marblegate argues that the history of Section 316(b) demonstrates Congress's broad intent to prohibit "an out-of-court debt restructuring that has the purpose and effect of eliminating <u>any</u> possibility of receiving payment under their notes."

The District Court concluded that the legislative history compels this interpretation because at the time that Section 316(b) was drafted Congress did not contemplate the use of foreclosures as a method of reorganization. This reading also reflects the District Court's understandable concern that "a sufficiently clever issuer [would] gut the Act's protections" by using a foreclosure action instead of amending the indenture or filing for bankruptcy.

Based on our review of the legislative history of Section 316(b), we conclude that Congress did not intend the broad reading that Marblegate urges and the District Court embraced.

Among other things, the drafters of the TIA appear to have been well aware of the range of possible forms of reorganization available to issuers, up to and including foreclosures like the one that occurred in this case but that the District Court concluded violated Section 316(b). Indeed, foreclosure-based reorganizations were widely used at the time the TIA was drafted.

Starting in 1936, the SEC published a comprehensive eight-part report examining the role of protective committees in reorganizations. * * * A section of the Report entitled "Protection of Minorities" confirms for us that "'no-action clauses' were one of the evils that the Trust Indenture Act was intended to address." * * * The other relevant section of the 1936 SEC Report, entitled "Reorganization by Contract," examined collective-action clauses. * * * In short, this section's focus on "reorganization by contract" supports reading Section 316(b) to prohibit amendments to core payment terms, but provides virtually no support for Marblegate's view that Section 316(b) also prohibits other forms of reorganization, such as foreclosures.

* * * *

Part VIII of the SEC Report, published a year after the TIA's enactment, reinforces our conclusion that foreclosures such as the one the District Court deemed prohibited in this case

were in fact contemplated by the drafters of Section 316(b). The 1940 SEC Report provided a comprehensive study of the decades-long use of foreclosure proceedings to effect reorganizations and constitutes a direct rejoinder to the District Court's assertion that the drafters of the TIA were unaware of such proceedings. Particularly compelling is the Report's discussion of the role of junior creditors in foreclosure-based reorganizations. In characterizing the choice faced by junior creditors when deciding whether to participate in foreclosure-based reorganizations, the 1940 SEC Report noted that "the participation in the plan given to junior creditors was the product of practical reasons, not legal compulsion." And in comparison to dissenting secured creditors entitled to a pro rata distribution of foreclosure proceeds, the 1940 SEC Report noted that if junior creditors "refused participation in the plan, they were thrown back to participation in such of the debtor's assets as to which senior creditors could lay no prior claims," which was "at best nominal." Finally, the 1940 SEC Report recognized that some States permitted private, non-judicial foreclosure sales to be used in reorganizations. Yet nowhere does the Report "suggest that reorganizations implemented through [private foreclosure sales] would conflict with a holder's right to receive payment," or that foreclosure-based reorganizations were prohibited by the TIA. To the contrary, the Report's only references to the TIA related exclusively to the power of the indenture trustee as an active representative of bondholders.

* * * *

Marblegate's interpretation of Section 316(b) requires that courts determine in each case whether a challenged transaction constitutes an "out-of-court debt restructuring . . . designed to eliminate a non-consenting holder's ability to receive payment." The interpretation thus turns on the subjective intent of the issuer or majority bondholders, not the transactional techniques used. But we have expressed a particular distaste for interpreting boilerplate indenture provisions based on the "relationship of particular borrowers and lenders" or the "particularized intentions of the parties to an indenture," both of which undermine "uniformity in interpretation." *See Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1048 (2d Cir. 1982).

* * * *

To summarize, we hold that Section 316(b) of the TIA does not prohibit the Intercompany Sale in this case. The transaction did not amend any terms of the Indenture. Nor did it prevent any dissenting bondholders from initiating suit to collect payments due on the dates specified by the Indenture. Marblegate retains its legal right to obtain payment by suing the EDM Issuer, among others. Absent changes to the Indenture's core payment terms, however, Marblegate cannot invoke Section 316(b) to retain an "absolute and unconditional" right to payment of its notes.

For the foregoing reasons, the judgment is **VACATED** and the case is **REMANDED** to the District Court for further proceedings consistent with this opinion.

STRAUB, J, DISSENTING:

The question before this Court is whether Section 316(b) of the Trust Indenture Act (the "TIA") prohibits Defendant-appellant Education Management Corporation ("EDMC") from

engaging in an out-of-court restructuring that is collusively engineered to ensure that certain minority bondholders receive no payment on their notes, despite the fact that the terms of the indenture governing those notes remain unchanged. Because the plain text of the statute compels the conclusion that it does, I would answer that question in the affirmative and uphold the judgment of the District Court. I therefore respectfully dissent.

I begin my analysis with the language of Section 316(b) of the TIA. In interpreting the language of the statute, I am guided by standard principles of statutory construction. Statutes should be read so as "to give effect, if possible, to every clause and word of a statute." *Duncan v. Walker*, 533 U.S. 167, 174, 121 S.Ct. 2120, 150 L.Ed.2d 251 (2001). Here, the plain language of Section 316(b) requires the conclusion that the Intercompany Sale as envisioned in the Restructuring Support Agreement violates the TIA.

Section 316(b) of the TIA reads as follows:

> **(b) Prohibition of impairment of holder's right to payment**
>
> Notwithstanding any other provision of the indenture to be qualified, ***the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security***, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, ***shall not be impaired or affected without the consent of such holder***. . . .

As delineated by the District court, "[t]he text poses two questions: what does the 'right . . . to receive payment' consist of, and when is it 'impaired or affected' without consent?" EDMC and the Steering Committee read the text narrowly, with EDMC arguing that "[o]n its face, the statutory text is unambiguous in protecting only the 'right' of a noteholder to receive payment when due and to sue for enforcement of such payment." By contrast, Marblegate reads the text broadly, arguing that "the right to receive payment is 'impaired' or 'affected' when the ability to receive payment under the bond is stripped away—not only through formal amendment of a bond's payment terms, but also by other means."

The terms "right," "impair," and "affect" are undefined in the TIA, so we must look to their ordinary meaning. A "right" is typically defined as "[s]omething that is due to a person by just claim, legal guarantee, or moral principle," or "[a] legally enforceable claim that another will do or will not do a given act." On the basis of this definition, Appellants argue that actions only violate Section 316(b) if those actions affect the "legal entitlement" to payment—i.e., by altering the terms of the bond so that a bondholder can no longer legally *claim* the right to receive payment under their original terms. Nothing in Section 316(b), Appellants urge, entitles bondholders to *actual* payment on their notes.

This argument, however, nearly eliminates the import of the terms "impair" and "affect" and imposes qualifications in Section 316(b) that simply do not exist. The term "impair" means "to diminish the value of." The term "affect" means "to produce an effect on; to influence in some way." Even defined as a "legal entitlement" or "claim," it is unquestionable that the "right" to receive payment can be "diminished" or "affected" without

actual modification of the payment terms of the indenture. By making it impossible for a company to pay the amount due on its notes, for example, the "right" to receive payment is "diminished" because it literally has been made worthless. Surely, a bondholder's right or "legal entitlement" to receive payment is impaired when actions are taken to ensure that the bondholder either consents to a change in his payment terms or receives *no* payment on his notes at all.

Had Congress intended merely to protect against modification of an indenture's payment terms, it could have so stated. Nothing in the language of Section 316(b), however, cabins the prohibition on impairing or affecting the "right . . . to receive payment" to mere *amendment* of the indenture. In fact, that Congress used the broad phrase "impaired or affected" implies that it did not intend Section 316(b) to be limited in its scope to mere amendments. Because we are compelled to give every term in a statute effect, our reading of the statute must account for rather than ignore this phraseology. Further, Section 316(b) is written in the passive voice; its prohibition is nowhere limited to actions taken by a noteholder majority. Despite Appellants' arguments to the contrary, nothing in the text of the statute requires the narrow reading that Section 316(b) merely prohibits modification of an indenture's core payment terms (amount and due date) by noteholder majority action without consent of the individual noteholder.

I am cognizant of the parade of horrors that Appellants predict will result from interpreting the TIA in the manner above. However, threatening dire commercial consequences from the refusal to read a statute in a manner inconsistent with its plain language is not a sufficient basis to override the correct interpretation of the law. We must not forget the long-standing imperative that *making* law is the job of the legislature and not of the courts. Where, as here, the statute's language is plain and unambiguous, the "sole function of the courts is to enforce it according to its terms." The bond market has surely undergone significant alterations since the enactment of the TIA, including that the main players are now sophisticated corporate entities on both sides. But it is not for this Court to alter the TIA on its own accord, and "none of this establishes why the plaintiffs should be barred from vindicating their rights under the [TIA]" as it currently stands.

CNH diversified Opportunities Master Account , L.P. v.
Cleveland Unlimited, Inc.
36 N.Y.3d 1 (2020)

GARCIA, J.

After the issuer defaulted, plaintiffs, the holders of a minority in principal amount of senior secured debt, brought this lawsuit against the debtor and its guarantors to recover payment of principal and interest. We are called upon to determine whether plaintiffs' right to sue for payment on the notes survived a strict foreclosure, undertaken by the trustee at the direction of a group of majority bondholders over plaintiffs' objection, that purported to cancel the notes. We hold that it did, and therefore modify the order of the Appellate Division by reversing the grant of summary judgment to the defendants and granting partial summary judgment to the plaintiffs.

In December 2005, defendant Cleveland Unlimited, Inc. (Cleveland Unlimited), a telecommunications company, issued $150 million of "senior secured" debt in the form of "notes" pursuant to an indenture agreement (the indenture). The notes had a five-year term and required Cleveland Unlimited to pay interest to holders of the notes (noteholders or holders) on a quarterly basis up to and including the maturity date, at which point the principal also became due. The indenture named Cleveland Unlimited as the "issuer" of the notes, 18 of Cleveland Unlimited's subsidiaries and affiliates as the "guarantors," and U.S. Bank National Association (U.S. Bank) as the indenture "trustee." At the same time the indenture was executed, the issuer, *the guarantors, and the trustee* executed a collateral trust agreement and a security agreement (collectively, indenture documents).[43] In April 2010, plaintiffs purchased approximately $5 million of the notes in the secondary market, amounting to 3.33% of the outstanding principal value.[44]

At issue in this case are certain provisions in the indenture documents governing the rights of the noteholders to receive payment, the remedies available in the event of default, and the power of a majority of noteholders to direct the trustee's choice of remedy. Section 6.07 of the indenture, titled "Rights of Holders To Receive Payment," provides:

> "Notwithstanding any other provision of this Indenture, the right of any Holder to receive payment of principal of, premium, if any, and interest and Additional Interest, if any, on a Note, on or after the respective due dates expressed in such Note, or to bring suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such Holder."

Section 6.07 tracks section 316(b) of the Trust Indenture Act of 1939 (TIA) . . . . The indenture was not qualified under the TIA, meaning that it was not an indenture that governed securities registered with the Securities and Exchange Commission . . . Nevertheless, *in addition* to restating some of the statutory language, the indenture incorporated by reference "[a]ny provision of the TIA which is required to be included in a qualified indenture."

Remedies in the event of default are set out in the indenture documents, and the trustee is authorized to take any available remedial action, including remedies available under the Uniform Commercial Code (*see* sections 6.03 and 12.08 of the indenture; section 9.1[viii] of the security agreement; section 3.1[a][4] of the collateral trust agreement). In addition to empowering the trustee with this broad authority, section 6.05 of the indenture, titled "Control by Majority," provides that "the Holders of a majority in principal amount of the outstanding Notes may direct the time, method and place of conducting any proceeding for exercising any remedy available to the Trustee." Section 6.05 tracks section 316(a) of the TIA . . .

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[43] The indenture also appointed U.S. Bank as the "collateral trustee." U.S. Bank, in its role as both indenture trustee and collateral trustee, will be referred to as the "trustee."

[44] Plaintiffs are CNH Diversified Opportunities Master Account, L.P., AQR Delta Master Account, L.P., AQR Delta Sapphire Fund, L.P., and AQR Funds—AQR Diversified Arbitrage Fund (collectively, minority noteholders or plaintiffs).

As the date for the payment of principal approached, and Cleveland Unlimited's financial situation deteriorated, the interplay among the provisions governing the noteholders' rights and remedies took on practical significance.

Interest payments on the notes were made, as scheduled, up to September 2010. In early December of that year, however, Cleveland Unlimited determined that it would not be able to pay the outstanding principal and interest shortly to come due. Seeking to avoid an event of default, Cleveland Unlimited entered into negotiations regarding potential workouts with the trustee and a committee of noteholders that owned over 99% of the outstanding principal value of the notes, including the minority noteholders and a separate group that owned 96.63% (majority noteholders).[45]

Despite those efforts, on December 15, 2010, Cleveland Unlimited defaulted on its obligation to pay the outstanding principal and interest now due. Discussions regarding potential restructuring transactions continued post-default. Several weeks later, the same committee executed a "forbearance agreement" with Cleveland Unlimited, the guarantors, the trustee, and CUI Holdings, LLC (CUI Holdings), an affiliate of Cleveland Unlimited that owned 100% of its stock. Pursuant to this agreement, CUI Holdings became a guarantor on the notes, pledging the Cleveland Unlimited stock as collateral, and the noteholders and the trustee agreed to refrain from exercising any rights or remedies available to them through April 2011.

On the same day that the forbearance agreement was executed, CUI Holdings and a new entity owned by the majority noteholders, CUI Acquisition Corp. (CUI Acquisition), negotiated a "purchase and sale agreement." Pursuant to this agreement, CUI Holdings would transfer all outstanding stock in Cleveland Unlimited to CUI Acquisition for the benefit of the noteholders. In return, the noteholders would forfeit their rights as secured creditors and, instead, become equity holders in Cleveland Unlimited, thereby relieving Cleveland Unlimited and the guarantors of their obligations under the notes. In April 2011, the minority noteholders informed the majority noteholders that they did not plan to participate in the purchase and sale agreement, opting to remain secured noteholders and seek full payment on the notes. The purchase and sale agreement failed to close by the end of the forbearance period.

In June 2011, counsel for the majority noteholders informed all noteholders that it had been "working with" the trustee on an alternative restructuring transaction, namely a "strict foreclosure" pursuant to sections 9-620 and 9-622 of the model UCC (*see UCC 9-620*; 9-622). According to counsel, this transaction "would enable [them] to maintain the structure of the [purchase and sale agreement] . . . *without requiring consent from all of the [holders*]."[46] Instead of reaching an agreement among all the noteholders, the trustee, at the direction of the majority noteholders, would "foreclose strictly" on the collateral that CUI Holdings had pledged

[45] "A workout is simply a contractually concluded modification of debt effected either by amendment of the terms of the existing debt or an exchange of the existing debt for new obligations" (William W. Bratton & Adam J. Levitin, *The New Bond Workouts, 166 U Pa L Rev 1597, 1604 [2018]*).

[46] Counsel's email indicates that the workout contemplated an additional loan to Cleveland Unlimited in the amount of $35 million. After the strict foreclosure, a senior secured loan in a similar amount was made by certain majority noteholders.

against the notes—100% of the outstanding stock in Cleveland Unlimited—and then distribute the stock on a pro rata basis to the noteholders, thereby cancelling the notes and ending the obligations of Cleveland Unlimited and the guarantors under the indenture.

The minority noteholders, in a letter sent to Cleveland Unlimited, the majority noteholders, and the trustee, asserted that they did not "join or in any way consent to the [strict foreclosure]." The letter explained that, "pursuant to [s]ection 6.07 of the Indenture and relevant sections of the [TIA]," the minority noteholders did not "consent to any impairment or effect on their rights to receive payment of principal . . . and interest" on their notes, "on or after the respective due dates, or to bring suit for the enforcement of any such payment on or after such respective dates."

Over the minority noteholders' objection, the strict foreclosure went forward. As the first step, the majority noteholders and the trustee entered into a "majority noteholder direction and indemnity agreement," in which the majority noteholders "directed" the trustee to "foreclose strictly" on the Cleveland Unlimited stock owned by CUI Holdings, "thereby extinguishing the indebtedness evidenced by the Notes."[47] The trustee complied with the majority noteholders' direction and, in turn, executed a "strict foreclosure agreement," pursuant to which CUI Holdings transferred its 100% equity stake in Cleveland Unlimited to the trustee for the benefit of the noteholders. The strict foreclosure agreement specified that the trustee's acceptance of the stock constituted a "full and final payment and satisfaction of" Cleveland Unlimited's "indebtedness evidenced by the Indenture . . . [and] the Notes."

On the same day as the execution of the strict foreclosure, the trustee advised *all* noteholders that the majority noteholders had "directed" the "Trustee to foreclose strictly on the Cleveland [Unlimited] Stock in full satisfaction of the Notes" and to distribute the stock to all noteholders on a pro rata basis. The trustee further advised the noteholders of the legal effect of the strict foreclosure, specifically that

> "by operation of law as a result of the strict foreclosure, the indebtedness evidenced by the Notes shall be deemed paid and cancelled and with limited exceptions, the obligations of [Cleveland Unlimited] under the Indenture shall be terminated. The rights of Holders will be limited to receiving their pro rata share of the aforementioned distribution [of Cleveland Unlimited stock] and no further distributions will be made to Holders on account of the Notes."

The trustee subsequently distributed the Cleveland Unlimited stock on a pro rata basis to the majority and minority noteholders.

Shortly after the strict foreclosure, a majority of the majority noteholders made a $34 million senior secured loan to Cleveland Unlimited at a 10% interest rate. When Cleveland

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[47] A secured party may accept collateral in full or partial satisfaction of the obligation (*see UCC 9-620[a]*). In a full *strict foreclosure*, the secured party *retains the collateral* in full satisfaction of the remaining debt, foreclosing any deficiency claim (*see UCC 9-622[a][1]*; Comment 2; *In re CBGB Holdings, LLC, 439 BR 551, 555 [SD NY 2010]*). In *a partial* strict foreclosure, the creditor retains the collateral, forgives part of the debt owed by the debtor, and sues the debtor for deficiency (*see UCC 9-622[a][1]*; Comment 2). In either case, the consent of the debtor and other secured creditors is required (*see UCC 9-620[a]-[b]*).

Unlimited was subsequently liquidated, the proceeds were used to pay that group of secured lenders the principal and outstanding interest owed on the loan. Ultimately, Cleveland Unlimited distributed approximately $13.5 million to its shareholders, but withheld any distribution to the minority noteholders pending resolution of this litigation.

Plaintiffs, the minority noteholders, commenced this action for breach of contract and breach of guaranty against Cleveland Unlimited and the guarantors, now including CUI Holdings (collectively, defendants), for payment of principal and interest on the notes, contending that, because they had not consented to the transaction, their right to payment and interest, and their right to bring suit to enforce those payment rights, had been impermissibly terminated. Defendants countered that plaintiffs' rights under the notes were extinguished by operation of the strict foreclosure, an enforcement mechanism expressly authorized by the terms of the *indenture documents*. Both parties moved for summary judgment. Supreme Court denied the minority noteholders' motion, and granted defendants' motion, dismissing the complaint . . . The court held that several provisions in the indenture documents, when *read* together, evidenced a "collective design" that authorized the trustee "to act for *all* the noteholders in the event of [Cleveland Unlimited]'s default, upon the direction of [the majority] noteholders" . . . .

Accordingly, the court held that the strict foreclosure was permissible under the parties' agreement, relying on this Court's decision in *Beal Sav. Bank v. Sommer (8 NY3d 318 [2007]*). Further, citing *Marblegate Asset Mgt., LLC v. Education Mgt. Fin. Corp. (846 F3d 1 [2d Cir 2017]*), the court held that the strict foreclosure did not violate section 316(b) of the TIA—or the equivalent language of section 6.07 of the indenture—because that transaction neither formally "amend[ed] any terms of the Indenture" nor "prevent[ed the minority noteholders] from bringing an action to collect payments due on the dates indicated in the Indenture" . . . . Despite granting summary judgment to defendants and dismissing the complaint, the court concluded that the minority noteholders *"retain[ed] the legal right to obtain payment by suing* Cleveland Unlimited as the issuer of the original notes" (*id.*).

The Appellate Division affirmed based on much of the same rationale, holding that "[a] fair reading of the [indenture documents] demonstrates that the . . . trustee was authorized to pursue default remedies, including the strict foreclosure at issue here, if so directed by a majority of the noteholders" . . . . The Appellate Division held that section 6.07 of the indenture did not supersede, nor conflict with, the sections of the indenture documents that authorized the trustee to take those remedies; rather, section 6.07 of the indenture, 'which tracks the language of' section 316(b) of the TIA, 'prohibits only non-consensual amendments to an indenture's core payment terms'" (*id. at 573-574*, quoting *Marblegate, 846 F3d at 3*). The strict foreclosure, the Appellate Division concluded, *"did not amend* the core payment terms in violation of section 6.07 of the Indenture, even if it had a similar effect" . . . .

This Court granted plaintiffs leave to appeal (*32 NY3d 914 [2019]*).

In order to determine whether plaintiffs may proceed against defendants in this action to recover outstanding principal and interest on the notes, we must examine whether plaintiffs' payment rights were, in fact, extinguished by the strict foreclosure, which purportedly cancelled their notes. As specified in the agreement between the parties to the *indenture documents*, New

York law controls (*see* section 11.07 of the indenture). Our case law makes clear that we approach the interpretation of the indenture provisions as a matter of basic contract law . . . . When reviewing an indenture, "particular words should be considered, not as if isolated from the context, but in the light of the obligation as a whole and the intention of the parties manifested thereby" (*Kolbe v. Tibbetts, 22 NY3d 344, 353 [2013]* [internal quotation marks and brackets omitted]). Applying these principles of contract interpretation, we turn to the language of the indenture provision underlying the dispute between the parties.

Section 6.07 provides that, "[n]otwithstanding" any other provision in the indenture, the rights of a noteholder to "receive payment" of principal and interest on the notes, and to "bring suit for the enforcement of any such payment . . . , shall not be impaired or affected without the consent of such Holder." Plaintiffs argue that the plain terms of this section prohibited the strict foreclosure from having the effect of extinguishing their legal rights to payment and to bring suit. Defendants maintain that the meaning of "impaired or affected" is ambiguous and cannot be read to cover the effect of the strict foreclosure, because those terms relate to only formal amendments to the core payment terms of the indenture.

Although the indenture is governed by New York law and is not qualified under the TIA, sections 6.05 and 6.07 of the indenture *incorporate* language from subsections (a) and (b) of section 316 of the TIA, respectively. Therefore, we may look to the TIA for guidance as to the intended application of those indenture provisions (*see Racepoint Partners, LLC v. JPMorgan Chase Bank, N.A., 14 NY3d 419, 423 [2010]* [parties' intent in the indenture provision may be equated with congressional intent with respect to the relevant section of the TIA]; *see generally* Felix Frankfurter, *Some Reflections on the Reading of Statutes*, 47 Colum L Rev 527, 537 [1947] ["if a word is obviously transplanted from another legal source, whether the common law or other legislation, it brings the old soil with it"]). In interpreting sections 6.05 and 6.07, we look to the structure and design of the corresponding TIA provisions . . . .

As the title of section 316 of the TIA announces, the provision covers "[d]irections and waivers by bondholders" and the "prohibition of impairment of holder's right to payment" . . . . The topics are not unrelated. Subsection (a) permits a qualified indenture to contain certain "majority action" or "collective action" clauses authorizing a majority in principal amount of the securities to: (1) "direct the time, method, and place of conducting any proceeding for any remedy available to such trustee"; and (2) "consent to the waiver of any past default and its consequences" on behalf of all security holders (*15 USC* . . . . A separate part of subsection (a) states that an indenture may contain a provision permitting the holders of at least 75% in principal amount of the indenture securities "to consent on behalf of the holders of all such indenture securities to the postponement of any interest payment for a period not exceeding three years from its due date" . . . .

Subsection (b), which is mandatory in all indentures governed by the TIA, serves as a limitation on the majority action authorized in subsection (a). The only exception to the blanket rule in subsection (b) is the ability of 75% of the security holders to postpone interest for a limited period of time provided for in subsection (a)(2) . . .; *Marblegate, 846 F3d at 14*). Accordingly, the other types of majority action permitted by subsection (a), namely the authority to excuse a

default and to direct trustee action in the event of a default, are constrained by subsection (b) (*see Kimmel v. State of New York*, *29 NY3d 386, 394 [2017]* [*"*where a statute creates provisos or exceptions as to certain matters(,) the inclusion of such provisos or exceptions is generally considered to deny the existence of others not mentioned*"*], quoting McKinney*'*s Cons Laws of NY, Book 1, Statutes § 240 at 412-413 [1971 ed]; *see e.g. Continental Bank & Trust Co. of N.Y. v. First Natl. Petroleum Trust, 67 F. Supp 859, 870-871 [D RI 1946]* [holding that, despite the unconditional language in subsection (a) permitting a majority of bondholders *"*to consent to the waiver of any past default,*"* an attempt by a majority group of bondholders to postpone or waive a default of an interest payment was nevertheless *"*directly contrary to the provisions of the (TIA) expressly prohibiting impairment of the right of a debenture holder to receive payment*"*]). Majority action with respect to remedies must be similarly constrained (*see In re Board of Directors of Telecom Argentina, S.A., 528 F.3d 162, 172 [2d Cir. 2008]* [recognizing that section 316(b) of the TIA *"*protects the holder of a bond issued under a qualified indenture from majority-imposed impairment of its rights*"*]; George W. Shuster, Jr., *The Trust Indenture Act and International Debt Restructurings, 14 Am Bankr Inst L Rev 431, 433 [2006]* [*"*section 316(b) protects the rights of each individual bondholder under an indenture as against other bondholders under that indenture*"*]). Indeed, the structure of the TIA demonstrates an intent to protect bondholders*'* legal rights to payment and to bring suit from the effects of collective action. The majority noteholders *were* empowered to act, without the consent of all noteholders, in directing a specific remedy—the strict foreclosure—and the trustee was authorized to follow that directive. However, the *purported cancellation* of the notes *cannot extinguish* the rights protected by section 6.07 of the indenture.

The dissent instead frames the issue as *"*whether the trustee was authorized to proceed with the strict foreclosure*"* (dissenting op at 22; *see also* dissenting op at 31. [*"*For an undisclosed reason, plaintiffs here chose not to sue the trustee for breach of its duties*"*]). There is no question that, here, the trustee was authorized to act. The issue is whether the minority noteholders*'* rights were extinguished—not *"*impair[ed]*"* (dissenting op at 30-31) —by the purported cancellation of the notes. A similar disconnect from the issue in this case leads the dissent to mine lengthy block quotes from the legislative history of the Barkley Bill, an earlier version of what became the TIA, concerning the *authorization* of a trustee to act at the direction of a majority of bondholders (*see* dissenting op at 29-30, citing Regulation of Sale of Securities: Hearing Before Subcomm of Comm on Banking and Currency of US Senate on S 2344, 75th Cong, 1st Sess. at 48, 66-67 [June 9, 1937] [statement of William O. Douglas, Commissioner, Securities and Exchange Commission] [hereinafter S 2344]). The discussion concerning the percentage of bondholders that could compel the trustee to act took place in the context of a bill that would have vested the Securities and Exchange Commission (SEC) with broad discretion to approve indenture terms (*see* Talcott M. Banks, Jr., *Indenture Securities and the Barkley Bill, 48 Yale LJ 533, 563 [1939]* [*"*the Commission*'*s power to create indenture clauses appears to be altogether unlimited*"*]). Commissioner William O. Douglas was addressing the concern that the SEC would qualify an indenture that contained a provision requiring 100% of the bondholders to authorize the trustee to take any specific course of action (*see* S 2344 at 48). As enacted, the TIA provides that, unless otherwise expressly excluded, the indenture will be deemed to include a

provision permitting a simple majority in principal amount of the securities to authorize the trustee to pursue an available remedy. In the same section of the TIA, however, certain core rights of minority bondholders are protected (*see Marblegate, 846 F.3d at 15 n 15* [*"*while the 1938 version of the bill vested discretion in the SEC to regulate indenture provisions, the 1939 version of the bill was altered to mandate that all qualified indentures contain certain provisions*"*]).[48]

Defendants maintain that, despite the language of the statute, cancellation of the notes by majority action authorized in subsection (a) of section 316 of the TIA does not violate the rights protected by subsection (b), relying on language in *Marblegate* that they claim limits the scope of subsection (b) to protection against *"*formal amendments*"* of *"*core payment terms*"* (*see 846 F.3d at 6-7, 14-15*). The strict foreclosure, defendants argue, did not effectuate such an amendment, and thus was not prohibited by subsection (b). Plaintiffs assert that *Marblegate*, when read correctly, supports their argument that the strict foreclosure could not be used to *extinguish* their rights to sue Cleveland Unlimited, the issuer—an entity that *"*remained intact with all its operating assets.*"* Plaintiffs are correct.

The *Marblegate* decision addressed a theory of recovery, adopted in a series of district court cases, which expanded the concept of impairment of the right to payment under section 316(b) of the TIA to include limitations on a bondholder*'*s *"*practical ability*"* to collect *00647-HE]*). The minority bondholder in *Marblegate* asserted that section 316(b) demonstrated *"*Congress*'*s broad intent to prohibit an out-of-court debt restructuring that has the purpose and effect of eliminating any possibility of receiving payment under their notes,*"* a view effectively adopted by the district courts. . . The Second Circuit, after a detailed examination of the transaction at issue and the resulting impact on minority payment rights, rejected that expansive reading of the statute . . .

The issuer in *Marblegate* had two layers of debt, secured and unsecured (*see 846 F.3d at 3*). Upon default, the secured creditors became the exclusive owners of the collateral, consisting of virtually all the issuer*'*s assets (*see id. at 3-4*). After failing to get unanimous creditor consent for a voluntary workout plan, an *"*Intercompany Sale*"* was initiated, pursuant to which the secured creditors would *"*first exercise their preexisting rights under the [at-issue credit agreement] and Article 9 of the [UCC] to foreclose on [the issuer]*'*s assets*" (id. at 4*). That action would serve to release a parent guarantee under both the secured and unsecured debt (*see id.*). The secured creditors then consented to the sale of the foreclosed assets to a newly-created subsidiary of the issuer, which would distribute debt and equity to only the consenting creditors (*see id.*). The plaintiff, a minority holder of unsecured notes, did not consent and sued to enjoin the intercompany sale on the ground that it violated section 316(b) of the TIA because it impaired the

[48] In the early drafts of the TIA, the language empowering majority bondholders to "direct the method and place of conducting all proceedings at law or in equity for any remedy under [the] indenture" appeared in the section detailing the duties of the trustee in the event of default, rather than the section on majority action and bondholders' rights (*see* Trust Indentures: Hearings Before Subcomm of Comm on Interstate & Foreign Commerce of House of Representatives on HR 10292, 75th Cong, 3d Sess. at 11-13 [Apr. 25, 1938]; Trust Indentures: Hearings Before Subcomm of Comm on Interstate & Foreign Commerce of House of Representatives on HR 2191 & HR 5220, 76th Cong, 1st Sess. at 11-14 [Apr. 4, 1939] [hereinafter HR 2191 & HR 5220]). At some point prior to the passage of the TIA, however, that language was incorporated into what became section 316 (*see 15 USC § 77ppp[a]*; HR 2191 & HR 5220 at 30-31).

practical ability to recover on the debt (*see id. at 5*). The Second Circuit held that section 316(b) was not violated because the plaintiff "retain[ed] its legal right to obtain payment by suing [the issuer], among others" (*id. at 17*). Absent changes to "core payments terms," the Second Circuit explained, the plaintiff could not "invoke [s]ection 316(b) to retain an absolute and unconditional right to payment of its notes" (*id.* [internal quotations marks omitted]).

As an initial matter, the phrase "changes to the . . . core payment terms" in *Marblegate* was used to describe the right to payment of principal and interest protected in section 316(b) of the TIA; it was not relevant to the right to bring suit (*see id. at 7, 17*; *see also Upic & Co. v. Kinder-Care Learning Ctrs., Inc., 793 F. Supp. 448, 454-455 [SD NY 1992]*). The plaintiff's unimpaired right to bring suit—also protected by section 316(b)—was crucial to *Marblegate's holding that there was no violation of section 316(b) (see 846 F3d at 16-17*; . . . . As the *Marblegate* court noted, with the plaintiff's right to bring suit unaffected by the out-of-court reorganization, section 316 (b) had not been violated because the plaintiff could pursue claims against the issuer and others (*see 846 F.3d at 16-17*).

The plaintiff in *Marblegate* needed to rely on a theory of interference with its "practical ability"—not its legal right—to receive payment (*id. at 2, 5, 7*). After all, the restructuring transaction left the issuer intact, thereby preserving the plaintiff's legal rights to sue the issuer and to receive payment, but making any chance of recovery remote.[49] With that right to bring suit intact, the Second Circuit expressly rejected the notion that section 316(b) of the TIA protects a noteholder's "practical ability" to recover payment in full and, instead, concluded that the provision was not violated by the transaction at issue (*see id. at 17*). Here, unlike in *Marblegate*, a minority holder of unsecured debt did not merely lose the "practical ability to collect payment" by virtue of a foreclosure accomplished by secured creditors (*id. at 2*). Rather, at the direction of the majority noteholders, the trustee initiated a strict foreclosure that, while leaving the intact issuer with its operating assets, cancelled the notes, terminating the minority noteholders' *legal* right to receive payment of principal and interest on the notes (*see* proposed brief of law professors as amicus curiae in support of plaintiffs-appellants' motion for leave to appeal at 7).

Defendants also argue that plaintiffs' rights were not violated because the transaction was authorized by section 6.05 of the indenture, which empowers the majority noteholders to "direct the time, method and place of conducting any proceeding for exercising any remedy available to the Trustee," including a strict foreclosure under the UCC. Because section 6.07 applies "[n]otwithstanding any other provision of this Indenture," however, the powers conferred upon the majority noteholders by section 6.05 are subject to the limitations in section 6.07. When a preposition such as "notwithstanding any other provision" is included in a contractual provision, that provision overrides any conflicting provisions in the contract . . . Therefore, the powers granted to the majority noteholders in section 6.05 cannot be used to extinguish the legal right to sue or the legal right to payment of non-consenting noteholders protected in section 6.07.

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[49] The minority bondholder in Marblegate was an unsecured junior creditor whose only guarantee was a "tag along," meaning "the guaranty had been created in connection with the [senior secured] loan and could be terminated at the [senior secured creditor]'s option" (Bratton & Levitin, *The New Bond Workouts, 166 U Pa L Rev at 1651* [internal quotation marks omitted]; *see Marblegate, 846 F.3d at 3-4*). Plaintiffs in this case, by contrast, are senior secured creditors with numerous guarantors securing the obligation.

The dissent agrees, recognizing that section 6.07 of the indenture, "which demand[s] the consent of each noteholder as a predicate to an action of the trustee that would impair or affect" the rights afforded to such noteholder under that section, overrides any conflicting indenture provision . . . . Nevertheless, the dissent argues that the strict foreclosure was authorized by the collateral trust agreement, namely section 3.3, which allows the trustee, at the direction of a group of majority noteholders, to take remedial action in the event of a default (dissenting op at 24). According to the dissent, this "adjustment of the indenture by operation of the collateral trust agreement *provided the consent* of the minority noteholders required in the indenture" (dissenting op at 25).

The noteholders *are not parties* to the collateral trust agreement, notwithstanding the dissent's suggestion to the contrary (*see* dissenting op at 27 [referring to "the consent given by the noteholders through the collateral trust agreement"]). Rather, the noteholders' consent to the terms of the collateral trust agreement is found *in the provisions of the indenture*. Section 12.01(b) of the indenture provides that the noteholders "consent[ ] and agree [ ] to the terms of" the collateral trust agreement and "authorize[ ]" the trustee "to perform its obligations and exercise its rights hereunder and thereunder in accordance herewith and therewith." Relatedly, section 12.08 of the indenture, titled "Authorization of Actions To Be Taken by the Collateral Trustee Under the Security Documents," provides that the noteholders "agree [ ]" that the trustee "may, in its sole discretion and without the consent of the . . . Holders, take all actions it deems necessary or appropriate in order to . . . enforce any of the terms of the . . . Collateral Trust Agreement." The only authorization—or consent—for the collateral trustee to act on behalf of the noteholders is found in the indenture, and, as with any other indenture provision, the authority granted in article 12 *must yield* to the "[n]otwithstanding" clause in section 6.07.[50]

* * * *

[T]he indenture in this case contained a specific provision, section 6.07, that affords each individual noteholder the absolute legal right to bring suit on its own behalf for payment of principal or interest, despite any "no-action clause" to the contrary (*see Cruden v. Bank of N.Y., 957 F.2d 961, 968 [2d Cir. 1992]; see also Marblegate, 846 F.3d at 7*). Further, the indenture contained another provision, section 6.06, which explicitly prescribes a noteholder's right to sue. . . .

We hold, consistent with the language, structure, and organization of the relevant indenture provisions and the TIA, that, under the circumstances here, the purported cancellation of the notes without the dissenting minority noteholders' consent violated section 6.07 of the indenture. Because we reject defendants' only defense on liability—the claim that any legal rights plaintiffs had to payment on the debt had been extinguished by the strict foreclosure, which

[50] The dissent references section 9.1 (viii) of the security agreement, stating that, "[t]o the extent it is relevant here," it "endows the trustee with the remedial power to, among other things, exercise in respect of the collateral all rights and remedies of a secured party on a default under the UCC" (dissenting op at 26 n 4). Section 11.1(a) of the security agreement, however, states that the actions of the trustee "are subject to the provisions of the Indenture." Accordingly, the power conferred upon the trustee by the security agreement is "subject to" the limitations imposed by section 6.07 of the indenture.

purportedly cancelled their notes without their consent—plaintiffs were entitled to partial summary judgment. . . .

Accordingly, the order of the Appellate Division should be modified, without costs, by denying defendants' motion for summary judgment, and granting partial summary judgment to plaintiffs, in accordance with this opinion.

Fahey, J. (dissenting). This decision needlessly disconnects the law of the two courts most relevant to the markets in which these securities are traded. Confusion will surely follow.

The majority opinion begins with what is presented as a relatively benign conclusion: "plaintiffs' right to sue for payment on the notes survived a strict foreclosure, undertaken by the trustee at the direction of a group of majority bondholders over plaintiffs' objection, that purported to cancel the notes" (majority op at 4). Lurking beneath that faulty premise is an alarming notion.

The majority strikes at the consistency between the law of this Court and that of the United States Court of Appeals for the Second Circuit with respect to the rules by which disputes related to an indenture of this nature are to be resolved. This matter is one that should be governed by basic principles of contract interpretation, and here there are two agreements that, when properly read as one, govern that review: the indenture, for which the majority accounts, and the collateral trust agreement, which the majority does not meaningfully consider. Those agreements were executed simultaneously and, when read together, they support the strict foreclosure course chosen by the trustee following the default of defendant Cleveland Unlimited, Inc. (Cleveland Unlimited) with respect to the notes in question.

The majority, however, brushes the collateral trust agreement aside. At the expense of both our rules of contract interpretation and the symmetry of such principles with those of the Second Circuit, the majority elevates the importance of the Trust Indenture Act of 1939 (TIA) (*see 15 USC § 77aaa*) to a place of undue prominence in determining this case.

Certainty of the law is an essential underpinning of financial dealings such as this one. The prudent, commonsense approach here would be to maintain that sureness and to avoid creating space between the rules of this Court and the rules of the Second Circuit governing the interpretation of indenture agreements. We should conclude that our steady rules of contract interpretation applied to the plain language of the contract in question authorize the strict foreclosure here at issue. For those reasons, we respectfully dissent and would affirm the Appellate Division order.

* * * *

§ 3.12 "CERTAIN RESTRUCTURING AND REORGANIZATION ISSUES"

Page 341: Add the following immediately before Problem A

In Re Energy Future Holdings Corp.
United States Court of Appeals, Third Circuit.
842 F.3d 247 (2016)

AMBRO, J

We address what happens when one provision of an indenture for money loaned provides that the debt is accelerated if the debtor files for bankruptcy and while in bankruptcy it opts to redeem that debt when another indenture provision provides for a redemption premium. Does the premium, meant to give the lenders the interest yield they expect, fall away because the full principal amount is now due and the noteholders are barred from rescinding the acceleration of debt? We hold no.

1. BACKROUND

A. The Notes

Energy Future Intermediate Holding Company LLC and EFIH Finance Inc. ("EFIH") borrowed in 2010 approximately $4 billion at a 10% interest rate by issuing Notes due in 2020 and secured by a first-priority lien on their assets (the "First Lien Notes"). To protect (at least in part) the lenders' anticipated interest-rate yield, the Indenture governing the loan (the "First Lien Indenture") provides in § 3.07, captioned "Optional Redemption," that "[a]t any time prior to December 1, 2015, [EFIH] may redeem all or a part of the Notes at a redemption price equal to 100% of the principal amount of the Notes redeemed plus the Applicable Premium . . . and accrued and unpaid interest." "Applicable Premium" is what we shall call the make-whole, or yield-protection, contractual substitute for interest lost on Notes redeemed before their expected due date.

The First Lien Indenture contains an acceleration provision in § 6.02 that makes "all outstanding Notes . . . due and payable immediately" if EFIH files a bankruptcy petition. The same provision also gives the First Lien Noteholders the right to "rescind any acceleration [of] the Notes and its consequences[.]"

EFIH borrowed funds again in 2011 and 2012 by issuing two sets of Notes secured by a second-priority lien on its assets (the "Second Lien Notes"). As with the First Lien Noteholders, EFIH promised to pay holders of the Second Lien Notes (the "Second Lien Noteholders") a make-whole premium—in a provision essentially identical to the one quoted above—if it chose to redeem the Second Lien Notes, at its option, on or before a date certain (May 15, 2016 for Second Lien Notes set to mature in 2021 and March 1, 2017 for those maturing in 2022).

The Indenture for the Second Lien Notes (the "Second Lien Indenture") contains an acceleration provision different from § 6.02 of the First Lien Indenture: if EFIH files a bankruptcy petition, "all principal of and premium, if any, interest . . .[,] and any other monetary obligations on the outstanding Notes shall be due and payable immediately[.]" Like the First

Lien Noteholders, the Second Lien Noteholders have the right to "rescind any acceleration [of] the Notes and its consequences" under § 6.02.

B. Refinancing the First Lien Notes

When market interest rates went down, EFIH considered refinancing the Notes. Refinancing outside of bankruptcy would have required it to pay the make-whole premium. By filing for bankruptcy, however, EFIH believed it might avoid the premium. So on November 1, 2013, it filed an 8–K form with the Securities and Exchange Commission "disclosing [its] proposal [whereby] . . . EFIH would file for bankruptcy and refinance the Notes without paying any make-whole amount."

Six months later, on April 29, 2014, EFIH and other members of its corporate family filed Chapter 11 bankruptcy petitions in the Bankruptcy Court for the District of Delaware. Once in bankruptcy, EFIH sought to "take advantage of highly favorable debt market conditions to refinance," beginning with the First Lien Notes. It asked the Bankruptcy Court for leave to borrow funds to pay them off and to offer a settlement to any of its First Lien Noteholders who agreed to waive their right to the make-whole.

Fearing loss of the income stream EFIH had promised, the Trustee for the First Lien Noteholders—Delaware Trust Company—filed an adversary proceeding on May 15, 2014. It sought a declaration that refinancing the First Lien Notes would trigger the make-whole premium.

EFIH's bankruptcy filing caused the "[First Lien] Notes [to] be[come] due and payable immediately" under Indenture § 6.02, subject to the right of their holders to rescind acceleration. So the Trustee also requested a declaration that it could rescind the First Lien Notes' acceleration without violating the automatic stay of creditors' acts to enforce their remedies once bankruptcy occurs. However, should the stay apply, the Trustee asked the Court to lift it.

When the Bankruptcy Court did not act, on June 4, 2014, the holders of a majority of the principal amount of the First Lien Notes sent a notice to EFIH rescinding acceleration, contingent on relief from the automatic stay. Two days later, the Bankruptcy Court granted EFIH's motion to refinance. It ruled, however, that the refinancing would not prejudice the First Lien Noteholders' rights in the pending adversary proceeding.

On June 19, 2014, EFIH paid off the First Lien Notes and refinanced the debt at a much lower interest rate of 4.25%, saving "an estimated $13 million in interest per month." This of course disadvantaged the First Lien Noteholders, who had contracted to receive interest at 10% until the Notes' full maturity in 2020. EFIH did not compensate the loss set by contract by paying the make-whole, which would have been approximately $431 million.

C. Refinancing the Second Lien Notes

Shortly after entering bankruptcy, EFIH declared in an SEC 8–K filing that it "reserve[d] the right to . . . redeem . . . some or all of the outstanding . . . Second Lien Notes" but asserted that it "[wa]s under no obligation to do so." Aware of this, as well as the First Lien

Noteholders' predicament, the Trustees for the Second Lien Noteholders filed their own adversary proceeding on June 16, 2014.

Like the First Lien Trustee, the Second Lien Trustees sought a declaration that EFIH would have to pay the make-whole if it chose to refinance the Second Lien Notes. The Second Lien Noteholders also issued a notice rescinding acceleration of that debt and requested retroactive relief from the automatic stay so that the rescission could take effect.

With the Bankruptcy Court's permission, EFIH refinanced a portion of the Second Lien Notes on March 10, 2015—again without paying the yield-protection amount.

D. First Lien Make-Whole Litigation

Nine months after granting leave to refinance the First Lien Notes, the Bankruptcy Court considered whether EFIH had to pay the make-whole. The holding was that it did not.

Although EFIH's obligation to pay the make-whole appears in § 3.07 of the First Lien Indenture, the Court focused its reasoning on the acceleration provision in § 6.02. Because it took effect when EFIH entered bankruptcy but made no mention of the make-whole, the Court concluded that none was due.

It further held that the automatic stay prevented the First Lien Noteholders' attempt to rescind the Notes' acceleration. Finally, after trial in 2015, it denied the Trustee's motion to lift the stay retroactively "to a date on or before June 19, 2014, to allow the Trustee to . . . decelerate the Notes.

These rulings put the First Lien Noteholders in a Catch–22. When EFIH filed for bankruptcy, the maturity of its debt accelerated. This, according to the Bankruptcy Court, cut off the First Lien Noteholders' right to yield-protection. Rescission of the acceleration would have restored that right. But rescission was blocked by the automatic stay, which the Court refused to lift.

E. Second Lien Make-Whole Litigation

The Second Lien Noteholders fared no better than the First Lien Noteholders. Six months after EFIH refinanced a portion of the Second Lien Notes, the Court considered the Second Lien Noteholders' entitlement to the make-whole. In construing the Second Lien Indenture's provisions, the Court adopted its findings and conclusions from the make-whole litigation for the First Lien Noteholders. After rejecting arguments based on the few differences between the First and Second Lien Indentures' texts, the Court held that the Second Lien Noteholders also were not entitled to yield-protection.

* * * *

A. The First Lien Indenture

Although both Indentures contain many provisions, this case centers on the words of but two: §§ 3.07 and 6.02. The former, noted earlier as titled "Optional Redemption," states when the make-whole is due: "At any time prior to December 1, 2015, the Issuer may redeem all or a part of the Notes at a redemption price equal to 100% of the principal amount of the Notes

redeemed plus the Applicable Premium [*i.e.*, the make-whole] . . . and accrued and unpaid interest." The premium decreases annually on a sliding scale between December 1, 2015 and November 30, 2018. From December 1, 2018 until the Notes' maturity date in 2020, the Notes may be optionally redeemed without payment of a premium.

Section 6.02 provides that on the filing of a bankruptcy petition by EFIH "all outstanding Notes shall be due and payable immediately without further action or notice."

Any duty to pay the make-whole comes from § 3.07. It leaves us with three questions: was there a redemption; was it optional; and if yes to both, did it occur before December 1, 2015?

Section 3.07 does not define "redemption." As a redemption "usu[ally] refers to the repurchase of a bond before maturity" EFIH contends that we should limit the term to mean only repayments of debt that pre-date the debt's maturity. Section 6.02 accelerated the Notes' maturity to the date EFIH entered bankruptcy—April 29, 2014. It refinanced the Notes several weeks later. Thus it argues that its post-maturity refinancing was not a redemption.

But contrary to that position, New York and federal courts deem "redemption" to include both pre- and post-maturity repayments of debt. . . .

Whether the redemption was "[o]ptional" is next up. EFIH argues that refinancing the Notes was not optional because § 6.02 made them "due and payable immediately without further action or notice" once it was in bankruptcy. EFIH, however, filed for Chapter 11 protection voluntarily. Once there, it had the option, per its plan of reorganization, to reinstate the accelerated Notes' original maturity date under Bankruptcy Code § 1124(2) rather than paying them off immediately. It chose not to do so, and instead followed the path laid out six months before in its SEC 8–K filing.

EFIH contends nonetheless that any redemption was mandatory rather than optional. But this contention does not match the facts. Indeed "a chapter 11 debtor that has the capacity to refinance secured debt on better terms . . . is in the same position within bankruptcy as it would be outside bankruptcy, and cannot reasonably assert that its repayment of debt is not voluntary . . . ."

Events leading up to the post-petition financing on June 19, 2014 demonstrate that the redemption was very much at EFIH's option. To repeat, months before its Chapter 11 filing EFIH announced its plan to redeem the Notes before their stated maturity date. And after filing for bankruptcy, it produced another 8–K stating that it may, "but [wa]s under no obligation" to, redeem the similarly situated Second Lien Notes.

The irony is that the Noteholders did not want to be paid back on June 19, 2014. They attempted to rescind the Notes' acceleration on June 4, 2014, but were blocked by the automatic stay. When EFIH redeemed the Notes, it did so "on a non-consensual basis," that is, over the Noteholders' objection. Logic leaves no doubt this redemption of the Notes was "[o]ptional" under § 3.07.

And, only to close the loop, all this occurred before December 1, 2015. Hence § 3.07 on its face requires that EFIH pay the Noteholders the yield-protection payment.

B. The Relationship Between § 3.07 and § 6.02 (Or Whether § 6.02 Once Triggered Annuls § 3.07)

At oral argument, EFIH's counsel described §§ 3.07 and 6.02 as "different pathways" that we must choose between. Only the latter is relevant, the argument goes, because it addresses post-maturity payment more specifically than § 3.07, and specific contract provisions govern over more general ones.

It is not obvious why EFIH believes § 6.02 addresses the consequences of the June 2014 redemption more specifically than § 3.07 or why we must choose between them. The two sections simply address different things: § 6.02 causes the maturity of EFIH's debt to accelerate on its bankruptcy, and § 3.07 causes a make-whole to become due when there is an optional redemption before December 1, 2015. Rather than "different pathways," together they form the map to guide the parties through a post-acceleration redemption. In any event, § 3.07 is the only provision that specifically addresses redemptions.

* * * *

EFIH *** argues that §§ 6.02 and 3.07 are in conflict, so that only one may apply to the June 2014 redemption. Subsection 3.07(e) prescribes detailed notice procedures for EFIH to follow before redeeming the Notes, while § 6.02 makes the Notes "due and payable immediately without further action or notice." If the notice procedures were not followed, no redemption could follow. Yet EFIH offers no reason why it could not have complied with § 3.07(e)'s notice procedures. In any event, it cannot use its own failure to notify to absolve its duty to pay the make-whole. Any conflict between the two provisions in this instance is illusory.

We know no reason why we should choose between §§ 3.07 and 6.02 when both plainly apply. By its own terms, § 3.07 governs the optional redemption embedded in the refinancing and requires payment of the make-whole. It surpasses strange to hold that silence in § 6.02 supersedes § 3.07's simple script.

C. The Second Lien Indenture's Additional Language

As mentioned above, the Second Lien Indenture's acceleration provision contains words not present in the First Lien Indenture. These additions make explicit in the Second Lien Indenture the link between acceleration under § 6.02 and the make-whole for an optional redemption per § 3.07. While for the First Lien Indenture these concepts are without cross-reference and separate, in the Second Lien Indenture they are tied together. Sections 3.07 and 6.02 are not merely compatible but complementary. In any event, the result is the same no matter the Indenture—there were optional redemptions before a date certain, thereby triggering make-whole premiums.

When EFIH filed its bankruptcy petition, Second Lien Indenture § 6.02 caused "all principal of and *premium, if any*, interest . . . [,] and any other monetary obligations on the outstanding [Second Lien] Notes [to] be[come] due and payable immediately." Compare First

Lien Indenture § 6.02 ("all outstanding Notes shall be due and payable immediately"). The words "premium, if any," are most naturally read to reference § 3.07's "Applicable Premium"—that is, the make-whole.

The most EFIH musters is that the Second Lien Indenture could have been even more specific by replacing "premium, if any," with "a premium owed under section 3.07" or "Applicable Premium or other premium owed as if repayment under this section were an Optional Redemption under section 3.07." But we see no reason to demand such exactness. Indeed, EFIH has not suggested any other "premium" the drafters could have had in mind.

* * * *

D. The Effect of Acceleration on Make-Whole Provisions

Notwithstanding the result dictated by § 3.07's text in both Indentures, EFIH asserts that it should not have to pay the make-whole because § 6.02 caused the Notes' maturity to accelerate before it paid them off. ***Citing a New York trial court opinion [*Nw. Mut. Life Ins. Co. v. Uniondale Realty Assocs.*, 816 N.Y.S.2d 831 (N.Y.Sup. Ct. 2006) ("Northwestern")], it argues that courts must close their eyes to make-whole provisions once a debt's maturity has accelerated.

***The New York Court of Appeals stated unequivocally in *NML Capital v. Republic of Argentina* that "[w]hile it is understood that acceleration advances the maturity date of the debt, [it was] unaware of any rule of New York law declaring that other terms of the contract not necessarily impacted by acceleration . . . automatically cease to be enforceable after acceleration." Put differently, contract terms like § 3.07 that are applicable before acceleration remain so afterward.

* * * *

Despite the New York Court of Appeals' holding in *NML Capital*, and still riding the *Northwestern* horse, EFIH contends that we should decline to require payment of the make-whole because the trial court declared that a "prepayment premium will not be enforced under default circumstances in the absence of a clause which so states[.]" *Northwestern*, 816 N.Y.S.2d at 836. It held that a mortgage lender who chose to foreclose following default was not entitled to a "prepayment premium" because foreclosure had advanced the debt's maturity date. ***According to EFIH, *Northwestern* sets a rule that, unless an agreement clearly provides for it, no make-whole payment is due after a note's acceleration.

Unlike prepayment, however, "redemption" of "a debt security" may occur "*at* or before maturity." Thus, while a premium contingent on "prepayment" could not take effect after the debt's maturity, a premium tied to a "redemption" would be unaffected by acceleration of a debt's maturity.

Our understanding of New York law is that it follows a logical path: prepayments cannot occur when payment is now due by acceleration of the debt's maturity. If parties want to mandate a "prepayment" premium following acceleration, they must clearly state it in their agreement. This is the *Northwestern* rule.

* * * *

Finally, by declining to enforce § 3.07 after acceleration, the Bankruptcy Court ran afoul of New York authority by failing to enforce a contract provision—§ 3.07—not affected by acceleration. *NML Capital*, 928 N.Y.S.2d 666, 952 N.E.2d at 492 . . . .

EFIH answers that the Noteholders should have taken note of bankruptcy courts' novel application of *Northwestern* and insisted on clearer language in the Indenture. But this puts the burden backward; if EFIH wanted its duty to pay the make-whole on optional redemption to terminate on acceleration of its debt, it needed to make clear that § 6.02 trumps § 3.07. The burden to make that showing is with EFIH. To place it on the Noteholders for EFIH's decision to redeem the Notes is a bridge too far.

* * * *

Our "primary objective . . . is to give effect to the intent of the parties as revealed by the language of their agreement." The language of the First Lien Indenture requires EFIH to pay a make-whole if it redeems the First Lien Notes at its option before December 1, 2015, and the Second Lien Indenture requires the same for redemptions of Second Lien Notes before May 15, 2016 or March 1, 2017 (depending on the initial maturity date of the particular debt instruments). EFIH redeemed the First Lien Notes at its option on June 19, 2014 and redeemed a portion of the Second Lien Notes on March 10, 2015. Redemptions, not prepayments, occurred here, they were at the election of EFIH, and they occurred before the respective dates noted. Statements of New York law by its highest Court and the federal Circuit Court in New York reinforce our conclusion that EFIH must pay the make-whole per the Indenture language before us.

The judgments of the District Court are reversed with instructions to remand to the Bankruptcy Court for further proceedings consistent with this opinion. Any future appeals shall return to this panel.

NOTE

1. A year later, the Second Circuit reached a contrary result in *In re MPM Silicones, LLC*, 874 F.3d 787 (2nd Cir. 2017), holding that an automatic acceleration of debt instruments by reason of a voluntary Chapter 11 filing did not constitute a voluntary redemption requiring the payment of a make whole premium.

2. Section 1112(b)(1) of the Bankruptcy Code allows dismissal of Chapter 11 petitions "for cause." "Although [S]ection 1112(b) does not explicitly require that cases be filled in 'good faith,' courts have overwhelmingly held that a lack of good faith in filing a Chapter 11 petition establishes cause for dismissal." *In re Marsch*, 36 F.3d 825, 828 (9th Cir. 1994).

The Court in *Marsch* dismissed the Chapter 11 petition because "it did not serve a legitimate purpose" and "because it was not filed in the best interest of the parties." The bankruptcy proceeding was commenced for the purpose of avoiding the payment of a judgment and posting an appeal bond. The Court reiterated that a "good faith" filing encompasses several

equitable limitations placed on Chapter 11 filings which cannot be used to *"*unreasonably deter and harass creditors*."* *In re Marsch*, 36 F.3d at 828. Likewise, the Court in *In re SGL Carbon Corp.*, 200 F.3d 154 (3rd Cir.1999) dismissed a Chapter 11 petition because the debtor had filed for bankruptcy in an attempt to avoid paying an antitrust judgement. The Court also noted that bankruptcy proceedings originated in the courts of equity, and equitable remedies are not available to any party who fails to act in an equitable fashion.

As the *In Re Energy Future*, Court noted, *"*[w]hen market interest rates went down, EFIH considered refinancing the Notes. Refinancing outside of bankruptcy would have required it to pay the make-whole premium. By filing for bankruptcy, however, EFIH believed it might avoid the premium*."* By focusing on Sections 3.07 and 6.02 of the Indenture, it appears that neither the creditors nor the Court raised a lack of good faith argument as a reason to dismiss the petition for cause.

The question can thus be posed whether a Chapter 11 filing by a solvent corporation with no indication of being in financial distress, for the sole purpose of circumventing a make-whole premium requirement evidences a lack of good faith. One cannot help but wonder whether a jurist such as the late Henry Friendly, who *"*often decided cases on the basis of what parties should have argued, whether or not they did so*"* would have at least considered the point.[51]

[51] David M. Dorsen, Henry Friendly, *Greatest Judge of His Era* 94 (2012).

Chapter 4

PREFERRED STOCK

§ 4.03 Excerpts From A Certificate Of Incorporation Authorizing The Issuance Of Preferred Stock

Page 348: add the following immediately above the NOTES

With reference to Article 4 of the certificate of incorporation on pages 345- 348, set forth below for purposes of comparison are older, more restrictive, preferred stock provisions. This Article grants to the *class* of Preferred Stock substantially more attributes than does the more streamlined Article Fourth in the Book. The latter's delegation of authority to the Board of Directors to fix the terms of various *series* is thus much broader in scope. There follows an example of an exercise by the Board of the granted authority.

FOURTH: The total number of shares of all classes of stock which the Corporation shall have authority to issue is one hundred million (100,000,000), of which twenty million (20,000,000) shares are to be Preferred Stock (hereinafter called the Preferred Stock), of the par value of one dollar ($1) each, and eighty million (80,000,000) shares are to be Common Stock (hereinafter called the Common Stock), of the par value of one dollar ($1) each.

The designations and the powers, preferences and rights, and the qualifications, limitations or restrictions thereof, of each class of stock of the Corporation which are fixed by this certificate of incorporation, and the express grant of authority to the Board of Directors to fix by resolution or resolutions the designations, and the powers, preferences and rights, and the qualifications, limitations or restrictions thereof, of the Preferred Stock which are not fixed by this certificate of incorporation, are as follows:

1. The Preferred Stock may be issued from time to time in any amount, not exceeding in the aggregate, including all shares theretofore issued and then outstanding of any and all series thereof, the total number of shares of the Preferred Stock hereinabove authorized, as Preferred Stock of one or more series, as hereinafter provided. All shares of any one series of the Preferred Stock shall be identical in all respects, each series thereof shall be distinctively designated by letter or descriptive words and, except as permitted by the provisions of this Article Fourth, all series of the Preferred Stock shall rank equally and be identical in all respects.

2. Authority is hereby expressly granted to the Board of Directors from time to time to issue the Preferred Stock as Preferred Stock of any series and in connection with the creation of each such series to fix by the resolution or resolutions providing for the issue of shares thereof the designations and the powers, preferences and rights, and the qualifications, limitations or restrictions thereof, of such series, to the full extent now or hereafter permitted by the laws of the State of Delaware, in respect of the matters set forth in the following subdivisions (a) to (g), inclusive:

(a) The designation of such series;

(b) The dividend rate of such series;

(c) The date or dates upon or after which the shares of such series shall be subject to redemption *at the election of the Corporation* and the redemption price or prices per share of such series on such redemption;

(d) The preference of the shares of such series over the Common Stock as to assets in the event of any liquidation, dissolution or winding up of the Corporation;

(e) Whether or not the shares of such series shall be entitled to the benefit of a sinking fund or purchase fund to be applied to the redemption or purchase of such series and, if so entitled, the amount of such fund and the manner of its application;

(f) Whether or not the shares of such series shall be convertible into, or exchangeable for, shares of any other class or classes or of any other series of the same class or of any series of any other class or classes of stock of the Corporation and, if so convertible or exchangeable, the conversion price or prices or rate or rates, or the rate or rates of exchange, and the adjustments, if any, in the price or prices or rate or rates at which such conversion or exchange may be made; and

(g) Whether the holders of shares of such series shall have voting powers in addition to the voting powers provided for in this Article Fourth and, if they are to have such additional voting powers, the extent thereof.

3. The powers, preferences and rights, and the qualifications, limitations and restrictions thereof, *applicable to the Preferred Stock of all series* are as follows:

(a) Out of the surplus or net profits of the Corporation legally available for dividends the holders of the Preferred Stock of each series shall be entitled to receive, when and as declared by the Board of Directors, dividends at the per annum rate determined as in this Article Fourth provided for such series, and no more, payable quarterly on the tenth days of March, June, September and December in each year (each such day being hereinafter called a dividend date and each quarterly period ending with a dividend date being hereinafter called a dividend period), in each case from the date of cumulation, as hereinafter in subdivision (e) of this Section 3 defined, of such series (provided, however, that, if the date of cumulation of such series shall be a date less than thirty (30) days prior to a dividend date, the dividend that would otherwise be payable on such dividend date will be payable on the next succeeding dividend date), before any sum or sums shall be set aside pursuant to subdivisions (b) or (f) of this Section 3 for the purchase or redemption of Preferred Stock of any series and before any dividend shall be declared or paid upon or set apart for, or any other distribution shall be ordered or made in respect of, or any payment shall be made on account of the purchase of, the Common Stock; and such dividends upon the Preferred Stock shall be cumulative (whether or not in any dividend period or periods there shall be surplus or net profits of the Corporation legally available for the payment of such dividends), so that, if at any time dividends upon the outstanding Preferred Stock of all series at the respective per annum rates determined as hereinabove specified for such series from the date of cumulation of each such series to the end of the then current dividend period shall not have been paid or

declared and a sum sufficient for the payment thereof set apart for such payment, the amount of the deficiency shall be fully paid, but without interest, or dividends in such amount declared on each such series and a sum sufficient for the payment thereof set apart for such payment, before any sum or sums shall be set aside pursuant to subdivisions (b) or (f) of this Section 3 for the purchase or redemption of Preferred Stock of any series and before any dividend shall be declared or paid upon or set apart for, or any other distribution shall be ordered or made in respect of, or any payment shall be made on account of the purchase of, the Common Stock.

All dividends declared on the Preferred Stock for any dividend period shall be declared *pro rata* so that the amounts of dividends per share declared for such period on the Preferred Stock of different series that were outstanding during such period shall in all cases bear to each other the same proportions that the respective dividend rates of such series for such period bear to each other.

(b) Out of any surplus or net profits of the Corporation legally available for dividends remaining after full cumulative dividends upon the Preferred Stock of all series then outstanding shall have been paid for all past dividend periods, and after or concurrently with making payment of, or declaring and setting apart for payment, full dividends on the Preferred Stock of all series then outstanding to the end of the then current dividend period and before any dividends shall be declared or paid upon or set apart for, or any other distribution shall be ordered or made in respect of, or any payment shall be made on account of the purchase of, the Common Stock, the Corporation shall set aside on its books when and as required, in respect of each series of the Preferred Stock any shares of which shall at the time be outstanding and in respect of which a sinking fund or purchase fund for the redemption or purchase thereof has been provided for in the resolution or resolutions providing for the issue of such shares, the sum or sums required by the terms of such resolution or resolutions as a sinking fund or purchase fund to be applied in the manner specified above.

(c) Out of any surplus or net profits of the Corporation legally available for dividends-remaining after full cumulative dividends upon the Preferred Stock of all series then outstanding shall have been paid for all past dividend periods, and after or concurrently with making payment of, or declaring and setting apart for payment, full dividends on the Preferred Stock of all series then outstanding to the end of the then current dividend period and after the Corporation shall have complied with the provisions of the foregoing subdivision (b) of this Section 3 in respect of any and all amounts then or theretofore required to be set aside or applied in respect of any sinking fund or purchase fund mentioned in said subdivision (b) and shall have made provision for compliance with said subdivision (b) in respect of the current sinking fund or purchase fund period for each series of Preferred Stock then outstanding and entitled to the benefit of a sinking fund or purchase fund, then and not otherwise, the holders of the Common Stock shall, subject to the provisions hereof, be entitled to receive such dividends as may from time to time be declared by the Board of Directors.

(d) The Preferred Stock of all series shall be preferred over the Common Stock as to assets in the event of any liquidation or dissolution or winding up of the Corporation, and in that event the holders of the Preferred Stock of each series shall be entitled to receive, out of the assets of the Corporation available for distribution to its stockholders, an amount determined as provided in this Article Fourth for every share of their holdings of the Preferred Stock of such series before any distribution of the assets shall be made to the holders of the Common Stock; and, if in the event of any such liquidation or dissolution or winding up the holders of all series of the Preferred Stock shall have received all the amounts to which they shall be entitled as aforesaid, the holders of the Common Stock shall be entitled, to the exclusion of the holders of the Preferred Stock of all series, to share ratably in all the assets of the Corporation available for distribution to the stockholders then remaining according to the number of shares of the Common Stock held by them respectively. If upon any liquidation or dissolution or winding up of the Corporation the amounts payable on or with respect to the Preferred Stock of all series are not paid in full, the holders of shares of the Preferred Stock of all series shall share ratably in any distribution of assets according to the respective amounts which would be payable in respect of the shares held by them upon such distribution if all amounts payable on or with respect to the Preferred Stock of all series were paid in full.

(e) The term "date of cumulation" as used in this Article Fourth with reference to the Preferred Stock of any series shall be deemed to mean the date on which shares of the Preferred Stock of such series are first issued.

In the event of the issue of additional shares of the Preferred Stock of any then existing series, all dividends paid on the Preferred Stock of such series prior to the issue of such additional shares, and all dividends declared and payable to holders of record of the Preferred Stock of such series on any date prior to the issue of such additional shares, shall be deemed to have been paid on such additional shares.

(f) All the Preferred Stock, or any series thereof, or any part of any series thereof, at any time outstanding may be redeemed by the Corporation (except as otherwise provided by the Board of Directors in accordance with Section 2 of this Article Fourth), at its election expressed by resolution of the Board of Directors, upon not less than thirty (30) days previous notice to the holders of record of the Preferred Stock to be redeemed, given by mail or by publication in such manner as may be prescribed by resolution of the Board of Directors, at the applicable redemption price, determined as provided in this Article Fourth, of the Preferred Stock to be redeemed; provided, however, that Preferred Stock may be redeemed only after full cumulative dividends upon the Preferred Stock of all series then outstanding shall have been paid for all past dividend periods, and after or concurrently with making payment of, or declaring and setting apart for payment, full dividends on the Preferred Stock of all series then outstanding (except the shares of the Preferred Stock to be redeemed) to the end of the current dividend period. If less than all the outstanding Preferred Stock of any series is to be redeemed, the redemption may be made either by lot or *pro rata* or in such fair and equitable other manner as may be prescribed by resolution of the Board of Directors.

From and after the date fixed in any such notice as the date of redemption (unless default shall be made by the Corporation in providing moneys for the payment of the redemption price pursuant to such notice), or, if the Corporation shall so elect, from and after a date (hereinafter called the date of deposit), prior to the date fixed as the date of redemption, on which the Corporation shall, provide moneys for the payment of the redemption price by depositing the amount thereof for account of the holders of the Preferred Stock entitled thereto with a bank or trust company doing business in the Borough of Manhattan, in The City of New York, and having capital and surplus of at least ten million dollars ($10,000,000) pursuant to notice of such election included in the notice of redemption specifying the date on which such deposit will be made, all dividends on the Preferred Stock called for redemption shall cease to accrue and all rights of the holders thereof as stockholders of the Corporation, except the right to receive the redemption price as hereinafter provided and, in the case of such deposit, any conversion rights not theretofore expired, shall cease and terminate. After the deposit of such amount with such bank or trust company, the respective holders of record of the Preferred Stock to be redeemed shall be entitled to receive the redemption price at any time upon actual delivery to such bank or trust company of certificates for the number of shares to be redeemed, duly endorsed in blank or accompanied by proper instruments of assignment and transfer thereof duly endorsed in blank. Any moneys so deposited which shall remain unclaimed by the holders of such Preferred Stock at the end of six (6) years after the redemption date, together with any interest thereon which shall be allowed by the bank or trust company with which the deposit shall have been made, shall be paid by such bank or trust company to the Corporation. Preferred Stock redeemed pursuant to the provisions of this subdivision shall have the status of authorized but unissued Preferred Stock.

(g) Except for such voting powers, if any, as are granted to the holders of the Preferred Stock by this subdivision (g) and subdivision (h) of this Section 3 or by law, or as may be granted by the Board of Directors to the holders of any one or more series of Preferred Stock in accordance with Section 2 of this Article Fourth, voting power shall be vested exclusively in the Common Stock. Holders of stock of whatever class entitled to vote shall be entitled to one vote for each share of stock held by them.

If at the time of any annual meeting of stockholders of the Corporation for the election of directors a default in preference dividends, as the term *"*default in preference dividends*"* is hereinafter defined, shall exist, (i) the holders of the Preferred Stock, voting separately as a class and without regard to series, shall have the right to elect two members of the Board of Directors but, except as provided in the following clause (ii), shall not be entitled to vote in the election of any of the other directors of the Corporation and (ii) if at the time of such meeting there shall be outstanding shares of more than one series of the Preferred Stock, *the holders of the Preferred Stock of each series, if any, of which more than 5,000,000 shares are then outstanding, voting separately as a series,* shall have the right to elect one member of the Board of Directors but, except as provided in the foregoing clause (i), shall not be entitled to vote in the election of any of the other

directors of the Corporation; and the holders of the Common Stock, voting separately as a class, shall be entitled to elect the other directors of the Corporation but shall not be entitled to vote in the election of the directors of the Corporation to be elected as provided in the foregoing clauses (i) and (ii). Whenever a default in preference dividends shall commence to exist, the Corporation, upon the written request of the holders of 5% or more of the outstanding shares of Preferred Stock or the holders of 5% or more of the outstanding shares of any series of Preferred Stock that would be entitled to elect a director of the Corporation pursuant to clause (ii) of the preceding sentence if an annual meeting of the stockholders of the Corporation for the election of directors were then being held, shall call a special meeting of the holders of the Preferred Stock and if, at the time of such request, there shall be outstanding shares of more than one series of the Preferred Stock, shall also call a special meeting of the holders of the Preferred Stock of each series, if any, of which more than 5,000,000 shares are then outstanding, such special meeting or meetings to be held within 120 days after the date on which such request is received by the Corporation for the purpose of enabling such holders to elect members of the Board of Directors as provided in clauses (i) and (ii) of the preceding sentence; provided, however, that such special meeting or meetings need not be called if an annual meeting of stockholders of the Corporation for the election of directors shall be scheduled to be held within such 120 days; and provided further that in lieu of any such special meeting, the election of the directors to be elected thereat may be effected by the written consent of the holders of a majority of the outstanding shares that would be entitled to be voted upon at such special meeting. Prior to any such special meeting or meetings, the number of directors of the Corporation shall be increased to the extent necessary to provide as additional places on the Board of Directors the directorships to be filled by the directors to be elected thereat. Any director elected as aforesaid by the holders of shares of the Preferred Stock or of any series thereof shall cease to serve as such director whenever a default in preference dividends shall cease to exist. If, prior to the end of the term of any director elected as aforesaid by the holders of shares of the Preferred Stock or of any series thereof, or elected by the holders of the Common Stock, a vacancy in the office of such director shall occur by reason of death, resignation, removal or disability, or for any other cause, such vacancy shall be filled for the unexpired term in the manner provided in the By-laws; provided, however, that if such vacancy shall be filled by election by the stockholders at a meeting thereof, the right to fill such vacancy shall be vested in the holders of that class of stock or series thereof which elected the director the vacancy in the office of whom is so to be filled, unless, in any such case, no default in preference dividends shall exist at the time of such election. For the purposes of this subdivision (g), a *"*default in preference dividends*"* shall be deemed to have occurred whenever the amount of dividends in arrears upon any series of the Preferred Stock shall be equivalent to six full quarter-yearly dividends or more, and, having so occurred, such default in preference dividends shall be deemed to exist thereafter until, but only until, all dividends in arrears on all shares of the Preferred Stock then outstanding, of each and every series, shall have been paid. The term *"*dividends in arrears*"* whenever used in this subdivision (g) with reference to the Preferred Stock of

any series shall be deemed to mean (whether or not in any dividend period in respect of which such term is used there shall have been surplus or net profits of the Corporation legally available for the payment of dividends) that amount which shall be equal to cumulative dividends at the rate expressed in the certificates for the Preferred Stock of such series for all past quarterly dividend periods less the amount of all dividends paid, or deemed paid, for all such periods upon such Preferred Stock. Nothing herein contained shall be deemed to prevent an increase in the number of directors of the Corporation pursuant to its By-laws as from time to time in effect so as to provide as additional places on the Board of Directors the directorships to be filled by the directors so to be elected by the holders of the Preferred Stock or of any series thereof, or to prevent any other change in the number of the directors of the Corporation.

(h) So long as any shares of the Preferred Stock of any series shall be outstanding,

(i) the Corporation shall not, without the affirmative vote or written consent of the holders of two-thirds of the aggregate number of shares of the Preferred Stock of all series at the time outstanding, considered as a class without regard to series,

(A) alter or change the powers, preferences or rights given to the Preferred Stock by this certificate of incorporation, so as to affect the Preferred Stock adversely, or

(B) authorize or create any class of stock ranking, either as to payment of dividends or distribution of assets, prior to the Preferred Stock; and

(ii) the Corporation shall not, without the affirmative vote or written consent of the holders of a majority of the aggregate number of shares of the Preferred Stock of all series at the time outstanding, considered as a class without regard to series, increase the authorized amount of the Preferred Stock or authorize or create any class of stock ranking, either as to payment of dividends or distribution of assets, on a parity with the Preferred Stock.

EXCERCISE OF BOARD OF DIRECTORS' AUTHORITY

RESOLVED that, pursuant to the authority expressly granted to and vested in the Board of Directors of the Corporation by the provisions of the Certificate of Incorporation of the Corporation, as amended, this Board of Directors hereby creates a series of the Preferred Stock, of the par value of one dollar ($1) each, of the Corporation (hereinafter called the Preferred Stock) to consist of not more than 6,697,538 shares of the Preferred Stock, and this Board of Directors hereby fixes the designation and the powers, preferences and rights, and the qualifications, limitations or restrictions thereof, of the shares of such series (in addition to the powers, preferences and rights, and the qualifications, limitations or restrictions thereof, set forth in the Certificate of Incorporation of the Corporation, as amended, which are applicable to the Preferred Stock of all series) as follows:

(a) The designation of the series of Preferred Stock created by this resolution shall be "$2.80 Series A Convertible Preferred Stock" (hereinafter called the Series A Preferred Stock).

(b) The dividend rate of the Series A Preferred Stock shall be $2.80 per share per annum.

(c) Shares of the Series A Preferred Stock may not be redeemed prior to March 31, 1973. On and after said date shares of such Stock shall be subject to redemption at the election of the Corporation and the redemption price of such Stock shall be $60 per share, plus an amount equal to the difference, if any, between (i) $2.80 per share per annum (with a proportionate amount for any portion of a year) from the date of the first issue of such shares to the date fixed by the Board of Directors of the Corporation (hereinafter called the Board of Directors) as the redemption date and (ii) the sum of the dividends paid or duly set aside for payment on a share of such Stock from the date of such first issue to the redemption date.

(d) The preference, as described in the Certificate of Incorporation of the Corporation, as amended, of the shares of the Series A Preferred Stock over the Common Stock of the Corporation (hereinafter called the Common Stock) as to assets in the event of any liquidation, dissolution or winding up of the Corporation shall be an amount equal to $60 per share, plus an amount equal to the difference, if any, between (i) $2.80 per share per annum (with a proportionate amount for any portion of a year) from the date of the first issue of such shares to the date fixed by the Board of Directors as the redemption date and (ii) the sum of the dividends paid or duly set aside for payment on a share of such Stock from the date of such first issue to the redemption date.

(e) The shares of the Series A Preferred Stock shall not be entitled to the benefit of any sinking fund or purchase fund to be applied to the redemption or purchase of the Series A Preferred Stock.

(f) (i) The shares of the Series A Preferred Stock shall be convertible at the option of the holders thereof at any time at the office or agency maintained by the Corporation in the Borough of Manhattan, The City of New York, for that purpose and at such other place or places, if any, as the Board of Directors may determine, into fully paid and non-assessable shares (calculated to the nearest 1/100 of a share) of the Common Stock at the rate of 1.33 shares of the Common Stock for each share of the Series A Preferred Stock; provided, however, that in case of the redemption of any shares of the Series A Preferred Stock, such right of conversion shall cease and terminate, as to the shares duly called for redemption, at the close of business on the date fixed for redemption, unless default shall be made in the payment of the redemption price. Upon conversion the Corporation shall make no payment or adjustment on account of dividends accrued or in arrears on the Series A Preferred Stock surrendered for conversion.

(ii) The number of shares of the Common Stock and the number of shares of other classes of the Corporation, if any, into which each share of the

Series A Preferred Stock is convertible shall be subject to adjustment from time to time only as follows:

(A) In case the Corporation shall (1) take a record of the holders of the Common Stock for the purpose of entitling them to receive a dividend declared payable in shares of the Common Stock, (2) subdivide the outstanding shares of the Common Stock, (3) combine the outstanding shares of the Common Stock into a smaller number of shares or (4) issue by reclassification of the Common Stock any shares of the Corporation, each holder of the Series A Preferred Stock shall thereafter be entitled upon the conversion of each share thereof held by him to receive for each such share the number of shares of the Corporation which he would have owned or have been entitled to receive after the happening of that one of the events described above which shall have happened had such share of the Series A Preferred Stock been converted immediately prior to the happening of such event, the adjustment to become effective immediately after the opening of business on the day next following (x) the record date or (y) the day upon which such subdivision, combination or reclassification shall become effective.

(B) In case of any consolidation or merger of the Corporation with or into another corporation, or in case of any sale or conveyance to another corporation of all or substantially all the property of the Corporation, each holder of the Series A Preferred Stock then outstanding and thereafter remaining outstanding shall have the right thereafter to convert each share held by him into the kind and amount of shares of stock, other securities, cash and property receivable upon such consolidation, merger, sale or conveyance by a holder of the number of shares of Common Stock into which such share might have been converted immediately prior to such consolidation, merger, sale or conveyance, and shall have no other conversion rights; in any such event, effective provision shall be made, in the certificate of incorporation of the resulting or surviving corporation or otherwise, so that the provisions set forth herein for the protection of the conversion rights of the shares of the Series A Preferred Stock shall thereafter be applicable, as nearly as reasonably may be, to any such other shares of stock, other securities, cash and property deliverable upon conversion of the shares of the Series A Preferred Stock remaining outstanding or other convertible stock or securities received by the holders in place thereof, and any such resulting or surviving corporation shall expressly assume the obligation to deliver, upon the exercise of the conversion privilege, such shares, other securities, cash or property as the holders of the shares of the Series A Preferred Stock remaining outstanding, or other convertible stock or securities received by the holders in place thereof, shall be entitled to receive

pursuant to the provisions hereof, and to make provision for the protection of the conversion right as above provided. In case securities other than Common Stock, cash or property shall be issuable, payable or deliverable by the Corporation upon conversion as aforesaid, then all reference in this paragraph (f) shall be deemed to apply, so far as appropriate and as nearly as may be, to such other securities, cash or property.

(C) In case the Corporation shall issue rights to all holders of the Common Stock entitling them (for a period expiring within 60 days after the record date for determination of stockholders entitled to receive such rights) to subscribe for or purchase shares of the Common Stock at a price per share less than the current market price per share of the Common Stock (as defined in Subsection (D) below) at such record date, the number of shares of the Common Stock into which each share of the Series A Preferred Stock shall thereafter be convertible shall be determined by multiplying the number of shares of the Common Stock into which such share of the Series A Preferred Stock was theretofore convertible by a fraction, of which the numerator shall be the number of shares of the Common Stock outstanding on the date of issuance of such rights plus the number of additional shares of the Common Stock offered for subscription or purchase, and of which the denominator shall be the number of shares of the Common Stock outstanding on the date of issuance of such rights plus the number of shares of the Common Stock which the aggregate offering price of the total number of shares so offered would purchase at such current market price. Such adjustment shall be made whenever such rights are issued and shall become effective retroactively immediately after the record date for the determination of stockholders entitled to receive such rights.

(D) For the purpose of any computation under Subsection (C) above, the current market price per share of the Common Stock at any date shall be deemed to be the average of the daily closing prices for the thirty (30) consecutive business days commencing forty-five (45) business days before the day in question. The closing price for each day shall be the last reported sales price regular way or, in case no such reported sale takes place on such day, the average of the reported closing bid and asked prices regular way, in either case on the New York Stock Exchange. The term "business day" as used in this Subsection (D) means any day on which said Exchange shall be open for trading.

(E) No fractional share of the Common Stock shall be issued upon any conversion but, in lieu thereof, there shall be paid to each holder of shares of the Series A Preferred Stock surrendered for conversion who but for the provisions of this Subsection (E) would be entitled to receive a fraction of a share on such conversion, as soon as practicable after the date

such shares are surrendered for conversion, an amount in cash equal to the same fraction of the market value of a full share of the Common Stock, unless the Board of Directors shall determine to adjust fractional shares by the issue of fractional scrip certificates or in some other manner. For such purpose, the market value of a share of the Common Stock shall be the last reported sales price regular way on the day immediately preceding the date upon which shares are surrendered for conversion, or, in case no such sale takes place on such day, the average of the reported closing bid and asked prices regular way on such day, in either case on the New York Stock Exchange.

(F) No adjustment in the number of shares of the Common Stock into which each share of the Series A Preferred Stock is convertible shall be required unless such adjustment would require an increase or decrease of at least 1/100th of a share in the number of shares of the Common Stock into which such share is then convertible; provided, however, that any adjustments which by reason of this Subsection (F) are not required to be made shall be carried forward and taken into account in any subsequent adjustment.

(G) Whenever any adjustment is required in the shares into which each share of the Series A Preferred Stock is convertible, the Corporation shall forthwith (I) keep available at each of its offices and agencies at which the Series A Preferred Stock is convertible a statement describing in reasonable detail the adjustment and the method of calculation used and (II) cause a copy of such statement to be mailed to the holders of record of the shares of the. Series A Preferred Stock.

(iii) The Corporation shall at all times reserve and keep available out of the authorized but unissued shares of the Common Stock the full number of shares of the Common Stock into which all shares of the Series A Preferred Stock from time to time outstanding are convertible, but shares of the Common Stock held in the treasury of the Corporation may in its discretion be delivered upon any conversion of shares of the Series A Preferred Stock.

(iv) The Corporation will pay any and all issue and other taxes that may be payable in. respect of any issue or delivery of shares of the Common Stock on conversion of shares of the Series A Preferred Stock pursuant hereto. The Corporation shall not, however, be required to pay any tax which may be payable in respect of any transfer involved in the issue and delivery of any shares of the Common Stock in a name other than that in which the shares of the Series A Preferred Stock so converted were registered and no such issue or delivery shall be made unless and until the person requesting such issue or delivery has paid to the Corporation the amount of any such tax or has established, to the satisfaction of the Corporation, that such tax has been paid.

(v) Shares of the Series A Preferred Stock converted into Common Stock shall have the status of authorized but unissued shares of Preferred Stock, but such shares shall not be reissued as shares of the Series A Preferred Stock.

(g) Except as may be otherwise herein or in the Certificate of Incorporation of the Corporation or by statute otherwise specifically provided, each holder of shares of the Series A Preferred Stock shall at every meeting of stockholders of the Corporation be entitled to one vote for each share of the Series A Preferred Stock held by such stockholder and the holders of the Series A Preferred Stock and of the Common Stock shall vote together as one class on any matter that may be brought before any such meeting.

(h) So long as any shares of the Series A Preferred Stock shall be outstanding, the Corporation shall not, without the affirmative vote or written consent of the holders of two-thirds of the aggregate number of shares of the Series A Preferred Stock at the time outstanding, alter or change the powers, preferences or rights of the Series A Preferred Stock as set forth in this resolution so as to affect the Series A Preferred Stock adversely.

Page 364: add the following immediately above § 4.04

In 2014, Sections 204 and 205, which appear in § 1.08, *supra*, were added to the Delaware General Corporation to overturn results such as that reached in *STARR Surgical,* which left a Delaware corporation unable to cure a statutorily defective stock issuance.

Section 204 permits the subsequent ratification of a *"*defective corporate act*"* if certain procedures are followed; however, under Section 204(h)(1), such an act can only be ratified if, *"*at the time such act or transaction was purportedly taken, [it] would have been within the power of the corporation . . . .*"* As a result of a 2018 amendment to Section 204, a corporate action although within the power of the corporation, but was not legally authorized is a *"*defective corporate act*"* which can be ratified under Section 204. The amendment was intended to overrule *Nguyen v. View, Inc*., *2017 WL 2439074 (Del. Ch. 2017)* in which the stock issuance sought to be cured pursuant to Section 204 had been effected *"*notwithstanding that the majority common stockholder had deliberately withheld his consent for the transaction – consent that was required for the transaction to be valid as a matter of law*"* *9, thus rendering the corporation without the power to issue the stock in question. The Court had held that a *subsequent* conversion of preferred stock resulting in *new* majority common stockholders of the corporation who thereupon purported to ratify the previously unauthorized stock issuance did not accomplish a Section 204 ratification.

Section 205 provides for judicial review of a purported Section 204 ratification and subsection (d) thereof permits the Court to consider equitable factors in its determination as to whether a defective corporate act should be given effect.

§ 4.08 THE INTERPRETATION AND EFFECT OF CLASS VOTING PROVISIONS

Page 424: Add the following above the NOTE

SECURITY NATIONAL BANK v. PETERS, WRITR AND CHRISTENSEN, INC.
Colorado Court of Appeals
569 P.2d 875 (1977)

BERMAN, JUDGE.

Plaintiffs, preferred shareholders of Peters, Writer and Christensen, Inc. (PWC), instituted this action on October 16, 1972, asserting two claims for relief against the directors of PWC. The first was a derivative claim under C.R.C.P. 23.1 for certain violations of the Colorado Corporation Code, and the second was a class action claim alleging fraud and breach of fiduciary duty. The defendants joined Thomas P. Owen as a third-party defendant on an indemnification theory. At the conclusion of a nonjury trial, the court held that plaintiffs' claims for relief were both based upon theories of fraud, and that the evidence presented would not sustain such a finding. Accordingly, a judgment of dismissal was entered in favor of defendants and the third-party defendant. The plaintiffs appeal from the judgment in favor of defendants, but no appeal was taken against the third-party defendant. We reverse.

PWC is a Colorado corporation and the individual defendants were directors and officers of PWC, each of whom held 16,000 of the 96,000 common Class A shares of PWC outstanding. The only voting shares of PWC were the common Class A shares.

In August 1963, a meeting of the directors and common shareholders of the company was held, at which time a plan was approved to sell the principal part of the business, its assets and property, and to liquidate and dissolve the company completely. Though the articles of incorporation required that the preferred shares be redeemed upon dissolution of the company, the preferred shareholders were not notified of the above meeting and were neither given an opportunity to vote at the meeting, nor an opportunity to file written objections or demands for the payment of the fair value of their shares as required by [an applicable statute]. Several of the defendants testified that they did not give the preferred shareholders notice of the above meeting on advice of counsel. Notice was not deemed necessary since the directors had adopted a plan to redeem the preferred shares within 12 months; however, notice of the planned redemption was never given to the preferred shareholders and the [redemption] plan was never carried out. On the basis of these facts, the trial court held that the directors had violated both the articles of incorporation and [an applicable statute].

In conformity with the dissolution plan, PWC sold substantially all of its assets, retaining only the common and preferred shares it held in the Atlantic Improvement Corporation. The Atlantic stock was initially restricted and could not be sold by PWC, but in March 1965, PWC received a "no action" letter from the SEC and thereafter the Atlantic stock could have been registered and sold. Until 1971, the value of the Atlantic stock was such that all preferred shares of PWC could have been fully redeemed; however, such a sale would not have generated sufficient monies to pay the common shareholders fully.

Several of the defendants testified that they did not sell the Atlantic stock because substantially all of the assets of Atlantic, which consisted of realty, had been condemned by the City of New York, and that it was their belief that the court award in the Atlantic condemnation suit would enable PWC to receive substantially more than the market value of its Atlantic shareholdings.

In 1964 and 1965, PWC did not pay five consecutive quarterly dividends to its preferred shareholders. The defendants testified that this action was taken on the advice of counsel for the purpose of preserving cash for the settlement of claims against the company. After failing to pay the above five dividends, the defendants were informed by the company bookkeeper that the preferred shareholders, pursuant to their stock subscription agreement, were entitled to assume control of the company if six dividends were missed. In an *"*Estimate of Potential Liquidation Value,*"* prepared by the bookkeeper, he wrote the defendants: *"*NOTHING HAS BEEN DONE THE PREFERRED STOCKHOLDERS GET THE COMPANY 6/1/65 UNLESS SOMETHING IS DONE.*"* Thereafter, defendants resumed paying dividends to the preferred shareholder, thereby preventing takeover of the company by the preferred shareholders.

At trial, plaintiffs asserted that these dividend payments were made while the capital of PWC was impaired in violation of [applicable statutes], but the trial court failed to rule on this matter, as will be discussed more fully below.

It is also relevant to note that in 1965, 1967, and 1970, PWC purchased shares of its preferred stock from three shareholders.

* * * *

II.

Plaintiffs*'* second claim for relief is a class action claim on behalf of the holders of the preferred stock of the company. The essence of this claim is that defendants breached their fiduciary duty towards plaintiffs and that they are liable to plaintiffs for all losses caused by this breach. Plaintiffs asserted that they were wrongfully denied notice of and an opportunity to vote at the 1963 shareholders meeting wherein the plan of liquidation and dissolution of PWC was approved, which in turn violated their right to file written objections or demands upon the corporation for the payment of the fair value of their shares pursuant to [an applicable statute]. It was further alleged that the above act was fraudulently concealed by the directors and that the applicable statute of limitations did not begin to run until discovery of the wrong. As stated previously, the trial court dismissed this action finding that fraud, actual or constructive, had not been proved. We hold that the court erred in finding that constructive fraud had not been proved.

Constructive fraud is defined as *"*a breach of duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive, violate confidence, or to injure public interests. . . . Neither actual dishonesty nor intent to deceive is an essential element of constructive fraud.*"* . . . Such fraud often arises where a special confidential or fiduciary relationship exists, which affords the power and means of one to take undue advantage over the other. . . . A breach of fiduciary duty constitutes constructive fraud. . . . And as we pointed out

previously, the directors of a corporation occupy just such a fiduciary relationship to the corporation and its stockholders. . . Moreover, constructive fraud, like *"*(a) constructive trust, is . . . (a) remedial device through which preference of self is made subordinate to loyalty to others.*"* *Meinhard v. Salmon*, *249 N.Y. 458, 164 N.E. 545, 62 A.L.R. 1 (1928)*.

Here, the record discloses the total lack of communication to the preferred shareholders as to the dissolution of PWC, as to their statutory right to have their shares redeemed, and as to what was generally happening in the corporation. The trial court correctly ruled that *"*(the directors) vote to liquidate the corporation without making provision for preferred shareholders . . . was in violation of the Articles of Incorporation (of PWC) and of the statute ([an applicable statute]).*"*

The decision to dissolve imposed certain duties on the directors, one of which was to redeem the preferred shares. The directors*'* stated reason for failing to redeem was that to do so would have required the sale of the Atlantic shareholdings. This the directors declined to do since they thought the Atlantic stock would greatly increase in value. However, any increase could only have benefited the common shareholders, for the preferred shareholders were limited by the articles of incorporation to receiving a fixed liquidation preference plus accumulated and unpaid dividends. In effect, the directors gambled with property which should have been used to redeem the preferred shares of PWC, and they did so without informing the preferred shareholders as to their plan. By these actions, the defendants breached the fiduciary duty they owed plaintiffs, and their conduct constitutes constructive fraud as a matter of law. . . .

Further, we note that together the four directors (including the third-party defendant) owned 64,000 shares of the common voting stock. This was a substantial amount when contrasted to the total outstanding of 96,000 voting shares. Thus, in addition to the fiduciary duties they owed as directors, they also owed fiduciary duties to the preferred stockholders because of their dominant and controlling stock ownership. *Seagrave Corp. v. Mount, supra*. No evidence indicates that they operated other than in unison in making the decisions which caused the plaintiffs*'* loss. Also, the evidence disclosed that although the preferred shares could have been fully redeemed until 1971 by selling the Atlantic stock held by PWC, at no time would such a sale have generated sufficient monies to pay off the common shareholders fully. Thus, the defendants, who occupied the dual position of controlling stockholders and directors of PWC, cannot be assumed to have exercised *"*an unprejudiced exercise of judgment . . .,*"* *Seagrave Corp. v. Mount, supra*,), . . . not just the *"*poor judgment*"* the trial court attributed to them.

In dismissing this claim for relief, it appears that the trial court based its decision solely on the fact that no actual fraud had been proved, saying, *"*I can find no showing of material misrepresentation, concealment of material facts, as appears in other cases involving corporate fraud. There were no fraudulent changes in the books, no misleading statement to shareholders.*"* Such findings, however, go to intent and relate to actual fraud, not constructive fraud. . . .

And, there is no support in the record for the court*'*s conclusion that constructive fraud had not been proved. Nor does the court*'*s finding that the *"*directors used poor judgment*"* relieve them from a charge of constructive fraud any more than does the fact that they may have acted in good faith without intent to deceive. . . Rather, the evidence and facts as found by the

court point with clarity to the constructive fraud complained of, that is, a fiduciary duty, and breaches thereof that are contrary to good conscience and which operate to injure another. . . .

We find the eloquence of Chief Judge Cardozo particularly apropos to the situation here:

> "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.
>
> Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court." *Meinhard v. Salmon, supra*.

Accordingly, we hold that the plaintiffs proved by clear and convincing evidence the fraud complained of, and that the trial court thus erred in ruling that constructive fraud had not been proved.

* * * *

[B] Judicial Construction of Preferred Stock and Statutory Voting Provisions

Page 426: Add the following above FLETCHER INTERNATIONAL, LTD. v. ION GEOPHYSICAL CORPORATION

CORRE OPPORTUNITIES FUND LP v. EMMIS COMMUNIATIONS CORP
United States District Court S.D. Indiana
892 F. Supp. 1076 (2012)

BARKER, DISTRICT JUDGE

* * * *

A. State Law Claims

1. Breach of Contract

Plaintiffs contend that Emmis's acquisition of Preferred Stock breached Section 3.3 of Emmis's Articles of Incorporation ("the Articles"), which governs the Preferred Shareholders' rights . . . .

a. Section 3.3

Section 3.3 provides in relevant part as follows:

> . . . [N]o Common Stock or any other stock of the Corporation ranking junior to or ratably with the Preferred Stock as to dividends . . . may be redeemed, purchased or otherwise acquired for any consideration . . . by the Corporation . . .

> unless full Accumulated Dividends shall have been or contemporaneously are paid or declared and a sum sufficient for the payment thereof is set apart for such payment on the Preferred Stock for all Dividend Payment Periods terminating on or prior to the date of such declaration, payment, redemption, purchase or acquisition.

It is undisputed that, between October 2011 and January 2012, Emmis acquired shares of Preferred Stock without first paying accumulated dividends to the Preferred Shareholders. Thus, we turn to the question of whether Preferred Stock constitutes stock "ranking junior to or ratably with the Preferred Stock." When interpreting contract terms, "[u]nless the terms of the contract are ambiguous, they will be given their plain and ordinary meaning . . . .

Plaintiffs contend that Defendants' acquisition of Preferred Stock without first paying dividends violated Section 3.3 because the phrase "any other stock . . . ranking junior to or ratably with the Preferred Stock" encompasses the Preferred Stock itself. Plaintiffs argue that the plain and ordinary meaning of "ratable" is "pro rata" or "proportional," and thus, that shares of Preferred Stock "rank ratably with" other shares of Preferred Stock as to dividends. In further support of their argument, Plaintiffs point to Section 7.3 of Emmis's Articles of Incorporation, which refers to: "shares of preferred stock which rank ratably with the Preferred Stock *(including the issuance of additional shares of the Preferred Stock)*." (emphasis added). Plaintiffs contend that because there is no indication that the phrase was intended to have varying definitions throughout the agreement, stock "ranking ratably with Preferred Stock" in Section 3.3 should be interpreted to include the Preferred Stock itself.

However, as Defendants argue, if the intent of Section 3.3 was in fact to prohibit Emmis's acquisition of the Preferred Stock itself, the Section would have provided that Emmis could only acquire stock ranking *senior* to the Preferred Stock or added the phrase "including the Preferred Stock" after "ratably with the Preferred Stock," as Section 7.3 of the Articles does. The fact that such language was used in Section 7.3 of the same agreement demonstrates that when the drafters intended to include Preferred Stock as stock that "ranks ratably" with itself, they knew how to make that distinction and they clearly expressed that intent. Because Section 3.3 does not include such a distinction, it suggests that the drafters did not intend that meaning to be read into the provision. Moreover, because Preferred Stock is Preferred Stock, it *is* logical to conclude that stock that ranks ratably *with* Preferred Stock must be some other series of stock.

For the foregoing reasons, we find that Plaintiffs have failed to establish that they have a reasonable likelihood of success in proving that Defendants' acquisition of Preferred Stock . . . constituted a breach of Section 3.3 of the Articles.

* * * *

§ 4.08 Interpretation And Effect Of Class Voting Provisions

Page 437: Add an S after the word Note, insert 2. in front of "The terms of" and add the following immediately under the word NOTES.

1. The proposed acquisition of Colt Industries, Inc (*"Colt"*) was structured as a first generation triangular merger in which Colt would have merged into a wholly owned subsidiary of the Penn Central Corporation. That acquisition structure was replaced by the second generation reverse triangular merger such as that described in the following *Warner Communications* decision, in which a subsidiary of the acquiring party merges *into* the acquired corporation. Some of the advantages of the second generation structure are discussed in the Note 1 following *Warner Communications.*

Page 446: Add the following immediately above Elliot Associates v. Avatex Corporation

NOTES

1. *Warner Communications* involved a *"*second generation*"* triangular merger (commonly referred to as a reverse triangular merger) in which the acquired corporation was the surviving corporation in its merger with a wholly owned subsidiary of the acquiring party. There are several advantages to such an acquisition structure, including that such a merger does not, for example, constitute an assignment by operation of law of a license of technology, and therefore such a merger does not violate an anti-assignment clause. *See Meso Scale Diagnostics*, *LLC v. Roch Diagnostics GMBH*, 62 A.3d, 62*,* 82 (Del. Ch. 2013) *"*Generally, mergers do not result in an assignment by operation of law of assets that began as property of the surviving entity and continued to be such after the merger*."* In addition, unlike a first generation triangular merger (in which the acquired corporation merges into the wholly owned subsidiary of the acquirer), it is not necessary to qualify the acquired corporation in states in which it is doing business because it is already so qualified. In either a first or second generation triangular merger, the liabilities of the acquired corporation are not assumed by the acquiring parent.

2. Although Chancellor Allen did not refer to it, his conclusion that Section 3.4(iii) was dispositive of the question as to whether the holder of the Warner Series B Preferred Stock had a separate class vote on the merger appears to be an application of the legal interpretation canon *generalia specialibus non dereogant*, which means in effect *"*the specific provision comes closer to addressing the very problem at hand and is thus more deserving of credence*."* *Antonin Scalia & Bryan A. Gardner, Reading Law: The Interpretation of Legal Texts* 183 (2012).

Page 460: Add the following above Federated Department Stores, Inc.

In Re Franchise Services Inc.
United States Court of Appeals, Fifth Circuit
891 F.3d 198 (2018)

KING, CIRCUIT JUDGE:

Under longstanding Supreme Court precedent, state law dictates the procedures a corporation must follow to authorize a bankruptcy filing. When those procedures place the

decision in the hands of the corporation's creditors, some courts have allowed the bankruptcy to proceed even though the creditors withheld consent. This case presents a related but distinct question: when the certificate of incorporation requires the consent of a majority of the holders of each class of stock, does the sole preferred shareholder lose its right to vote against (and therefore avert) a voluntary bankruptcy petition if it is also a creditor of the corporation?

In this case, the shareholder made a $15 million investment in exchange for 100% of the debtor's preferred stock. At the same time, the debtor reincorporated in Delaware and amended its certificate of incorporation. As a prerequisite to filing a voluntary bankruptcy petition, the amended certificate requires the consent of a majority of each class of the debtor's common and preferred shareholders. Following the ill-fated acquisition of a new subsidiary, the debtor filed for bankruptcy. Fearing that its shareholders might nix the filing, it never put the matter to a vote. The sole preferred shareholder filed a motion to dismiss the bankruptcy petition as unauthorized. But the debtor argued that the shareholder had no right to prevent the filing. The shareholder's parent company, explained the debtor, was an unsecured creditor by virtue of a $3 million bill the debtor refused to pay. The bankruptcy court disagreed and dismissed the petition. On appeal, the debtor asks us to reverse and to allow it to proceed with the bankruptcy.

We decline to do so. Federal law does not prevent a bona fide shareholder from exercising its right to vote against a bankruptcy petition just because it is also an unsecured creditor.[52] Under these circumstances, the issue of corporate authority to file a bankruptcy petition is left to state law. The debtor is a Delaware corporation, governed by that state's General Corporation Law. Finding nothing there that would nullify the shareholder's right to vote against the bankruptcy petition, we affirm.

The debtor in this case is Franchise Services of North America ("FSNA")—once one of the largest car rental companies in North America. Among FSNA's competitors is the Hertz Corporation. In 2012, the Hertz Corporation was trying to consummate a merger with Dollar Thrifty Automotive Group, Inc. Antitrust concerns prompted Hertz to sell one of its subsidiaries, Simply Wheelz, LLC, better known under its trade name, Advantage Rent-A-Car ("Advantage").

FSNA decided to buy Advantage. To do so, it enlisted the help of an investment bank, Macquarie Capital (U.S.A.), Inc. ("Macquarie"). Adreca Holdings Corporation ("Adreca"), one of Macquarie's subsidiaries, would first buy Advantage from Hertz and then merge into FSNA. Adreca bought Advantage in December 2012 and merged into FSNA in May 2013.

Macquarie created another fully-owned subsidiary to help finance the transaction. Boketo, LLC ("Boketo"), was formed in 2012 to make a $15 million investment in FSNA. In exchange for the capital infusion, FSNA gave Boketo 100% of its preferred stock in the form of a convertible preferred equity instrument. Boketo's stake in FSNA would amount to a 49.76% equity interest if converted, making it the single largest investor in FSNA. As a condition of the investment, FSNA in May 2013 reincorporated in Delaware and adopted a new certificate of

[52] As we note later in this opinion, our holding goes no further. This case involves a bona fide shareholder. The equity investment made by the shareholder at issue here was $15 million and the debt just $3 million. We are not confronted with a case where a creditor has somehow contracted for the right to prevent a bankruptcy or where the equity interest is just a ruse.

incorporation. The new certificate provides that FSNA may not "effect any Liquidation Event" unless it has the approval of both "(i) the holders of a majority of the shares of Series A Preferred Stock then outstanding, voting separately as a class . . ., and (ii) the holders of a majority of the shares of Common Stock then outstanding, voting separately as a class." Another section of the certificate clarifies that any "preparatory steps towards or filing a petition for bankruptcy" falls within the ambit of "Liquidation Event."

FSNA agreed to pay Macquarie a $2.5 million "arrangement fee" and a $500 thousand "financial advisory fee" for its services. Macquarie billed FSNA for the arrangement fee in March 2013, shortly before the merger closed. That fee remains unpaid and is the subject of litigation between the parties in other forums.[53]

Matters quickly took a turn for the worse. It turned out that FSNA had bought a lemon. Advantage went into bankruptcy within a year, and FSNA followed just a few years later. Advantage filed its petition under Chapter 11 of the Bankruptcy Code just six months after the acquisition. A sale of substantially all of Advantage's assets ensued, and the case was dismissed in January 2016. In June 2017, FSNA filed its own voluntary petition under Chapter 11. It did so without requesting or securing the consent of a majority of its preferred and common shareholders.

Therein lies the rub. Macquarie and Boketo filed a motion to dismiss the bankruptcy petition, citing FSNA's failure to seek shareholder authorization. FSNA countered that the shareholder consent provision was an invalid restriction on its right to file a bankruptcy petition. It also asserted that the provision violated Delaware law. The bankruptcy court held an evidentiary hearing on the matter during which it heard live testimony from two witnesses. Because Boketo was an owner, rather than creditor, of FSNA, the bankruptcy court determined that conditioning FSNA's right to file a voluntary petition on Boketo's consent was not contrary to federal bankruptcy policy. The court likewise declined to deem the shareholder consent provision contrary to Delaware law. It instead opted to leave that issue for the Delaware courts to decide in the first instance. As a result, the court granted Boketo's motion to dismiss.

On FSNA's motion, the bankruptcy court certified a direct appeal of its order to this court . . . . After finding that FSNA's proposed questions were too narrow to warrant certification of a direct appeal, the bankruptcy court certified the following three questions to this court:

> 1. Is a provision, typically called a blocking provision or a golden share, which gives a party (whether a creditor or an equity holder) the ability to prevent a corporation from filing bankruptcy valid and enforceable or is the provision contrary to federal public policy?

[53] The parties' briefing makes clear that the bankruptcy case is but one front in a larger conflict. In one case in New York state court, Macquarie is suing to collect its fees. FSNA has counterclaimed for its loss of capital value, blaming Macquarie for its tribulations. We need not dwell on the details of the various hostilities. They do not affect our analysis of federal bankruptcy law.

2. If a party is both a creditor and an equity holder of the debtor and holds a blocking provision or a golden share, is the blocking provision or golden share valid and enforceable or is the provision contrary to federal public policy?

3. Under Delaware law, may a certificate of incorporation contain a blocking provision/golden share? If the answer to that question is yes, does Delaware law impose on the holder of the provision a fiduciary duty to exercise such provision in the best interests of the corporation?

* * * *

Before moving to the merits of this case, we must first narrow the questions presented. The bankruptcy court certified three broad questions to this court, each of them involving the enforceability of "a provision, typically called a blocking provision or a golden share." As an initial matter, these terms are not synonymous, nor have they been precisely defined. Courts appear to use the term "blocking provision" as a catch-all to refer to various contractual provisions through which a creditor reserves a right to prevent a debtor from filing for bankruptcy . . . .

Generally speaking, a "golden share" is "[a] share that controls more than half of a corporation's voting rights and gives the shareholder veto power over changes to the company's charter." *E.g.*, Golden Share, Black's Law Dictionary (10th ed. 2014); *see also* Mariana Pargendler, *State Ownership and Corporate Governance, 80 Fordham L. Rev. 2917, 2967 (2012)* (noting that in the context of formerly stated-owned entities, "[g]olden shares are essentially a special class of stock issued to the privatizing government that grants special voting and veto rights that are disproportionate to, or even independent of, its cash-flow rights in the company"). As used in the bankruptcy context, the term generally refers to the issuance to a creditor of a trivial number of shares that gives the creditor the right to prevent a voluntary bankruptcy petition, potentially among other rights . . . .

We need not dwell on whether this case involves a "blocking provision" or a "golden share." The facts do not fit neatly into either definition. Boketo made a $15 million equity investment in FSNA. In return, FSNA issued convertible preferred stock to Boketo, amounting to 100% of its preferred stock. The preferred stock carried with it the right, granted in the certificate of incorporation, to vote on certain corporate matters.

* * * *

In this case, we decline to answer the bankruptcy court's first certified question regarding the enforceability of "blocking provisions" and "golden shares" generally . . . . Instead we confine our analysis to whether U.S. and Delaware law permit the parties to do what they did here: amend a corporate charter to allow a non-fiduciary shareholder fully controlled by an unsecured creditor to prevent a voluntary bankruptcy petition.

A bankruptcy case can be initiated in one of two ways. A qualified "debtor," *see 11 U.S.C. § 109*, can file a voluntary petition, *see Id. § 301*. Or, subject to certain requirements and

limitations, creditors can file an involuntary petition against the debtor.[54] *See Id. § 303(a)-(b). This case concerns a voluntary petition filed under Chapter 11 of the Bankruptcy Code. Id. §§ 1101-1174*. A corporation like FSNA is a qualified debtor under Chapter 11. *See Id. § 109(a)-(b), (d)*. It may therefore file a voluntary petition under that chapter. *See Id. § 301*. But a corporation cannot act on its own; it can act only if authorized by appropriate agents . . . . The Bankruptcy Code provides that an *"*entity that may be a debtor*"* may commence a voluntary case by filing a petition. *See 11 U.S.C. § 301(a)*. Still, when the entity is a corporation that can act only through its agents, the Bankruptcy Code does not specify who may file a petition on its behalf.

*"*In absence of federal incorporation, that authority finds its source in local law.*" Price v. Gurney, 324 U.S. 100, 106, 65 S.Ct. 513, 89 L.Ed. 776 (1945)*. State law thus determines who has the authority to file a voluntary petition on behalf of the corporation. *See id. at 106-07, 65 S.Ct. 513* . . . If the petitioners lack authorization under state law, the bankruptcy court *"*has no alternative but to dismiss the petition.*" Price, 324 U.S. at 106, 65 S.Ct. 513*. *"*It is not enough that those who seek to speak for the corporation may have the right to obtain that authority.*" Id.* Rather, they must have it at the time of filing. *See id. at 106-07, 65 S.Ct. 513*. Absent a duly authorized petition, the bankruptcy court has no power *"*to shift the management of a corporation from one group to another, to settle intracorporate disputes, and to adjust intracorporate claims.*" Id.*

FSNA contends that even assuming Delaware law authorizes the arrangement here, federal law would forbid it. Federal law forbids the arrangement, in FSNA's view, not because it is contrary to any specific statute or binding caselaw, but instead because it violates a federal public policy against waiving the protections of the Bankruptcy Code. Several courts of appeals —though not this one—have opined that a pre-petition waiver of the benefits of bankruptcy is contrary to federal law and therefore void . . . Boketo agrees that a debtor cannot contract away the protections of bankruptcy. [This] case does not involve a contractual waiver of the right to file for bankruptcy or to a discharge. As this case is framed, we can assume without deciding that such a waiver is invalid. We leave the resolution of that issue for another case, one in which it is squarely presented.

Instead, this case involves an amendment to a corporate charter, triggered by a substantial equity investment, that effectively grants a preferred shareholder the right to veto the decision to file for bankruptcy. In FSNA's view, this is just a wolf in sheep's clothing—a creditor masquerading as a bona fide equity owner. Boketo is fully controlled by Macquarie, meaning the veto right in fact belongs to Macquarie—an unsecured creditor by virtue of its unpaid fees. In support of its argument, FSNA cites a slew of bankruptcy court cases. These cases all involve arrangements whereby a lender extracts an amendment to the organization's foundational documents granting the lender a veto right in exchange for forbearance . . . .

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[54] Though not relevant to this case, the partners of a partnership or "a foreign representative of the estate in a foreign proceeding concerning" the debtor may also file an involuntary petition. *See 11 U.S.C. § 303(b)(3)-(4)*.

. . . Even treating Boketo and Macquarie as a single entity,[55] there is no evidence that their arrangement was merely a ruse to ensure that FSNA would pay Macquarie's bill. In 2012, Macquarie, through Boketo, took a substantial equity stake in FSNA, buying convertible preferred stock for $15 million. In 2013, Macquarie issued an invoice for the $2.5 million arrangement fee.[56] FSNA would have us believe the tail wags the dog. It strains credulity to believe that Macquarie made a $15 million equity investment just to hedge against the possibility that FSNA might not pay a $3 million bill. We do not doubt that Macquarie would have preferred to avoid the cost and inconvenience of trying to collect some portion of its $3 million fee as an unsecured creditor in bankruptcy.[57] But if it was anxious about whether FSNA would fail to pay the fee, then it was just throwing good money after bad—$15 million of good money. FSNA points to no evidence that would allow us to set aside our incredulity and conclude that Macquarie invested $15 million in FSNA to ensure payment of a $3 million bill.[58]

The Supreme Court held more than seventy years ago that corporate authority to file for bankruptcy "finds its source in local law." *See Price, 324 U.S. at 106, 65 S.Ct. 513*. FSNA has provided us no reason to depart from that general rule in this case. There is no prohibition in federal bankruptcy law against granting a preferred shareholder the right to prevent a voluntary bankruptcy filing just because the shareholder also happens to be an unsecured creditor by virtue of an unpaid consulting bill. "It is one thing to look past corporate governance documents and the structure of a corporation when a creditor has negotiated authority to veto a debtor's decision to file a bankruptcy petition; it is quite another to ignore those documents when the owners retain for themselves the decision whether to file bankruptcy." *In re Squire Court Partners, 574 B.R. at 708; see also In re Glob. Ship Sys., LLC, 391 B.R. 193, 199, 203 (Bankr. S.D. Ga. 2007)* (holding that owner of 20% equity stake and $18 million debt "wears two hats" and may exercise a right to prevent a voluntary bankruptcy petition). In sum, there is no compelling federal law rationale for depriving a bona fide equity holder of its voting rights just because it is also a creditor of the corporation.

FSNA urges that even if a shareholder-creditor could hold a bankruptcy veto right, such a right remains void in the absence of a concomitant fiduciary duty. But FSNA offers no good

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[55] The bankruptcy court found that Macquarie fully controlled Boketo and, as we do, assumed for the sake of argument that the companies were one and the same. Although FSNA derides Boketo as a "paper company," there is nothing inherently improper or suspicious about creating a limited liability entity in order to facilitate an investment. At the hearing on this motion, both parties' witnesses testified that this practice is "very common" and "typical."

[56] It is not clear from the record when Macquarie billed FSNA for the $500 thousand financial advisory fee.

[57] Boketo's position in bankruptcy is actually worse than Macquarie's. Shareholders are the residual claimants of the estate, see *11 U.S.C. § 726(a)(6)*, entitled only to whatever remains after payment of the various secured and unsecured creditors, see id. *§§ 507, 726; cf. Torch Liquidating Tr. ex rel. Bridge Assocs. L.L.C. v. Stockstill, 561 F.3d 377, 385 (5th Cir. 2009)* ("When a corporation is insolvent . . . its creditors take the place of the shareholders as the residual beneficiaries of any increase in value." (emphasis removed) (quoting *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007)*)).

[58] FSNA repeatedly alleges throughout its brief that Boketo was trying to force it to draw on a $7.5 million Boketo line of credit. FSNA therefore labels Boketo a "potential" creditor. But FSNA admits that it never drew on the line of credit, regardless of the pressure it may have felt to do so. Consequently, the existence of the untapped line of credit is immaterial to the outcome of this case.

legal or logical rationale for such a holding. No statute or binding caselaw licenses this court to ignore corporate foundational documents, deprive a bona fide shareholder of its voting rights, and reallocate corporate authority to file for bankruptcy just because the shareholder also happens to be an unsecured creditor. *Cf. Price, 324 U.S. at 106, 65 S.Ct. 513* ("[U]nder the Bankruptcy Act the power of the court to shift the management of a corporation from one group to another, to settle intracorporate disputes, and to adjust intracorporate claims is strictly limited to those situations where a petition has been approved."). The bankruptcy court opinions FSNA cites are not controlling and not to the contrary. They involve creditors' attempts to appoint non-fiduciary officers and directors with the ability to prevent a bankruptcy filing . . . .

This is not an advisory opinion, and our holding is limited to the facts actually presented in this case. We hold simply that federal bankruptcy law does not prevent a bona fide equity holder from exercising its voting rights to prevent the corporation from filing a voluntary bankruptcy petition just because it also holds a debt owed by the corporation and owes no fiduciary duty to the corporation or its fellow shareholders. A different result might be warranted if a creditor with no stake in the company held the right. So too might a different result be warranted if there were evidence that a creditor took an equity stake simply as a ruse to guarantee a debt. We leave those questions for another day.

We turn now to the main event: does Delaware law allow Boketo to exercise the blocking right? Authority to file for bankruptcy is, after all, a matter of state law. *See Price, 324 U.S. at 106-07, 65 S.Ct. 513*. This question has two parts. First, whether Delaware law allows parties to provide in the certificate of incorporation that the consent of both classes of shareholders is required to file a voluntary petition for bankruptcy. Second, whether Delaware law would impose a fiduciary duty on a minority shareholder with the ability to prevent a voluntary bankruptcy petition.

This is not a diversity case. But because we apply state law to determine whether a corporate bankruptcy petition was properly authorized, the same principles apply. In evaluating issues of state law, we look to the decisions of the state's highest courts . . . . In the absence of a controlling decision, we make an *"Erie*[59] guess" as to how the state's highest court would resolve the issue . . . . Unless persuaded that the state's highest court would decide the issue differently, we also defer to the decisions of the state's intermediate appellate courts . . . . To determine corporate authority to file for bankruptcy, we apply the law of the state of incorporation—here, Delaware. *See Price, 324 U.S. at 104 & n.1, 106, 65 S.Ct. 513*

Under the Delaware General Corporation Law, a certificate of incorporation "may" contain:

> Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, or the governing body, members, or any class or group of members of a nonstock corporation; if such provisions are not contrary to the laws of this State.

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[59] *Erie R. Co. v. Tompkins*, 304 U.S. 64, 58 S.Ct. 817, 82 L.Ed. 1188 (1938).

Del. Code tit. 8, § 102(b)(1). As a default rule, "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors." *Id. § 141(a)*. There is, however, an exception to the default rule: the management prerogative rests with the board, "except as may be otherwise provided in this chapter or in its certificate of incorporation." *Id.* If the certificate departs from the default rule, then "the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation." *Id.*

"Delaware's corporate statute is widely regarded as the most flexible in the nation." *Jones Apparel Grp., Inc. v. Maxwell Shoe Co., 883 A.2d 837, 845 (Del. Ch. 2004)*. Instead of dictating a rigid structure, "it leaves the parties to the corporate contract (managers and stockholders) with great leeway to structure their relations, subject to relatively loose statutory constraints." *Id.* "*Sections 102(b)(1)* and *141(a)* . . . embody Delaware's commitment to private ordering in the charter." *Id.* In light of that commitment and the "broad effect" of these statutes, Delaware courts do "not lightly find that certificate provisions are unlawful." *Id. at 845-46*. A provision is not contrary to Delaware law just because it withdraws traditional power from the board. The "obvious purpose" of *§ 141(a)* "is to permit (absent some conflict with Delaware public policy) certificate provisions to withdraw authority from the board." *Id. at 852*.

We nonetheless decline to resolve whether the shareholder consent provision violates Delaware law. In the bankruptcy court, FSNA argued that the shareholder consent provision is invalid under Delaware law. On appeal, however, FSNA has expressly waived any such argument, stating that the "abstract question as to whether Delaware would ever allow a blocking provision need not be debated." When a party expressly waives an issue or argument, we lack the benefit of adversarial briefing and generally decline to consider the issue . . . . We have all the more reason to do so here. The parties have not identified, and we have not discovered, any on-point Delaware cases. We decline to decide in the first instance whether the Delaware General Corporation Law would tolerate a provision in the certificate of incorporation conditioning the corporation's right to file a bankruptcy petition on shareholder consent.[60] For the purposes of this case, we assume it would.

* * * *

For the foregoing reasons, we [a]ffirm [the bankruptcy court.]

NOTE

In an unreported bench ruling involving a non – majority preferred stock holder of the debtor who was not also a creditor of the entity, a Delaware Bankruptcy Judge expressly declined to follow the Fifth Circuit's *Franchise Services* opinion in *In Re Pace Indus., LLC*, 2020 Bankr. LEXIS 2266 (Banker D. Del. May 5, 2020), stating that: "I do believe that, under Delaware state law, contrary to the Fifth Circuit's interpretation of that law, would and does find that a that a blocking right, such as exercised in the circumstances of this case, would create a fiduciary duty that, with the debtor in the zone of insolvency, is owed to not only other shareholders, but all creditors . . . . And I think that, whether or not the person or entity is a creditor or s

[60] The bankruptcy court declined to decide this issue for the same reason.

shareholder, federal public policy does require that the Court consider what is in the best interests of all . . . ." *39

§ 4.09: Redemption Provisions

Page 471: Add the following above § 4.10

Taylor v. Taylor
Supreme Court of Idaho
163 Idaho 910, 422 P. 3d 1116 (2018)

BURDICK, CHIEF JUSTICE.

Donna Taylor (Donna) appeals the Nez Perce County district court's judgment regarding her Series A Preferred Shares in AIA Services Corporation (AIA). In 1987, Donna received 200,000 Series A Preferred Shares in AIA as part of a divorce settlement. . . . AIA discontinued paying Donna for the redemption of her shares, prompting her to file suit. Donna alleged several causes of action against AIA, with the primary issue being whether Donna is entitled to have her shares redeemed at the prime lending rate plus one-quarter percent. AIA contends that any agreement providing that interest rate is unenforceable, and instead Donna's redemption is governed by AIA's amended articles of incorporation, which provide the interest rate as the prime lending rate minus one and one-half percent. . . . [T]he district court determined Donna's share redemption was governed by AIA's amended articles of incorporation, and as such, all but 7,110 of Donna's shares had been redeemed. Donna timely appealed, and AIA along with individual defendants, cross appealed several of the court's determinations. For reasons discussed below, we reverse in part and remand.

Donna and her husband Reed Taylor (Reed) created AIA in 1983. Donna and Reed divorced in 1987, and as part of the divorce settlement, Donna received 200,000 Series A Preferred Shares in AIA, making her the sole owner of all outstanding Series A Preferred Shares issued by the corporation. AIA's articles of incorporation were amended in 1987 to reflect Donna's agreement and provided that her shares would be redeemed over a fifteen-year amortization schedule at the prime lending rate less one and one-half percent. In 1993, Donna provided a written demand to AIA to redeem her Series A Preferred Shares. In December 1993, Donna began receiving payments from AIA in the amount of $15,000 per month, increasing in 1995 to $24,000 per month which she received until February 2001.

In January 1995, AIA sought to reorganize and Donna, along with AIA, entered into an agreement memorialized in four letters (1995 Letter Agreement) that changed the redemption of Donna's shares to a ten-year amortization schedule at the prime lending rate plus one-quarter percent.

In June 2015, defendants . . . [asked the district court to declare the 1995 Letter Agreement illegal]. The defendants filed a declaration to demonstrate [that there was no] record the shareholders had ever authorized a higher interest rate than [that] provided by the articles of incorporation. In light of the new evidence, the district court held that it was now uncontroverted that the AIA shareholders never voted to pay a higher interest rate than [that contained] in the articles of incorporation and therefore the 1995 Letter Agreement was illegal. Thus, the court

held, the only equitable remedy was to recalculate the [previous] redemptions of Donna's shares at the only lawful interest rate—the rate established by the 1987 articles of incorporation which was the prime lending rate minus one and one-half percent. The court determined that Donna had received $2,696,797.80 in payments to redeem her shares since 1993. Using a calculation provided by AIA, the court held that applying the lawful rate of prime minus one and one-half percent, all but 7,110 of Donna's shares had been redeemed. Thus, the court entered judgment . . . that Donna holds 7,110 unredeemed Series A Preferred Shares in AIA . . . .

Donna subsequently moved for reconsideration and to set aside the judgment, which the district court denied. Donna timely appealed to this Court.

* * * *

The . . . issue is whether the terms in the 1995 Letter Agreement are enforceable. While the district court initially determined the 1995 Letter Agreement was enforceable, on reconsideration, AIA presented evidence that shareholders had never voted to pay Donna a higher interest rate than authorized in the articles of incorporation. In light of this evidence, the district court found the 1995 Letter Agreement was illegal and unenforceable. For reasons discussed below, the district court's analysis was in error.

* * * *

[T]he . . . issue is what effect is given to the terms providing for the higher interest rate and shorter amortization schedule that are contained in the January 11, 1995 [Letter Agreement]. As discussed below, the terms governing Donna's redemption in the [1995 Letter Agreement] conflicted with the terms in the articles of incorporation, and therefore constituted an *ultra vires* act, rather than an illegal one. Thus, when the district court determined that the 1995 Letter Agreement was illegal because it provided for a higher interest rate than in the articles, it erred.

An *ultra vires* act is an act that is "[u]nauthorized; beyond the scope of power allowed or granted by a corporate charter or by law." *Ultra Vires*, *Black's Law Dictionary* 1755 (10th ed. 2014); *see also Carlson, 17 Idaho at 742-433, 107 P. at 755-56*. Idaho Code section 30-1-7 was applicable at the time of the agreement and provided for an affirmative defense of *ultra vires*, stating in relevant part:

> No act of a corporation and no conveyance or transfer of real or personal property to or by a corporation shall be invalid by reason of the fact that the corporation was without capacity or power to do such act or to make or receive such conveyance or transfer, but such lack of capacity or power may be asserted:
>
> (a) In a proceeding by a shareholder against the corporation to enjoin the doing of any act or the transfer of real or personal property by or to the corporation. . . .
>
> (b) In a proceeding by the corporation . . .
>
> (c) In a proceeding by the attorney general . . .

"[T]he defense of *ultra vires* is special, must be specially pleaded and proven, and cannot be raised for the first time on appeal." *Wallace Bank & Tr. Co. v. First Nat. Bank, 40 Idaho 712, 722, 237 P. 284, 287 (1925)*.

We have said "that the doctrine of *ultra vires*, when invoked for or against a corporation, should not be allowed to prevail where it would defeat the ends of justice or work a legal wrong." *Power Cty. v. Evans Bros. Land & Live Stock Co., 43 Idaho 158, 166, 252 P. 182, 183 (1926)*. "Especially is this true where the contract has been executed in good faith by the party seeking to enforce it." *Id., 252 P. at 183-84*. Regarding contracts, this Court has held that competent parties who have received the benefit of the contract are estopped from asserting a defense of *ultra vires*. *Id. at 168, 252 P. at 184* ("it would be eminently unjust both to plaintiff and the other sureties were the defendant company permitted to escape the consequences of this contract evidently undertaken in good faith by all of the parties, and in good faith performed by all of them save appellant."); *Fremont Cty. v. Warner, 7 Idaho 367, 370, 63 P. 106, 107 (1900)* ("the defendants were competent parties, and, having received the benefits of the contract, they are now estopped from setting up the defense of *ultra vires*.").

In this case, the 1995 Letter Agreement was an *ultra vires* act because it purported to authorize the redemption of Donna's shares at an interest rate higher than authorized in the articles of incorporation without shareholder approval. Thus, the "corporation was without capacity or power to do such act" when it entered into the 1995 Letter Agreement with Donna. I.C. § 30-1-7 (1995). However, AIA did not plead a defense of *ultra vires*, and it cannot be raised for the first time on appeal. *Meholin v. Carlson, 17 Idaho 742, 743, 107 P. 755, 756 (1910)* ("The question of *ultra vires* must be pleaded, and cannot for the first time be raised in the appellate court."). Even if AIA had pleaded a defense of *ultra vires*, which it did not, the defense would not be successful here. The 1995 Letter Agreement was entered into in good faith by competent parties, and AIA received the benefit of the agreement in that it allowed AIA the opportunity to reorganize. AIA cannot now assert *ultra vires* to "escape the consequences of this contract[.]" *See Power Cty., 43 Idaho at 168, 252 P. at 184*. Because the 1995 Letter Agreement was an *ultra vires* act, rather than an illegal act, the 1995 Letter Agreement is enforceable. I.C. § 30-1-7 ("No act of a corporation and no conveyance or transfer of real or personal property to or by a corporation shall be invalid by reason of the fact that the corporation was without capacity or power to do such act"). Accordingly, the district court's order that the 1995 Letter Agreement is unenforceable is reversed.

We reverse the district court's dismissal of Donna's breach of contract claim as it relates to the 1995 Letter Agreement, and we remand for proceedings consistent with this opinion.

Whitebox Concentrated Convertible Arbitrage Partners, L.P. v. Superior Well Servs., Inc.
New York Court of Appeals
20 N.Y.3d 59, 980 N.E.2d 487 (2012)

GRAFFEO, J.

In this case we are

I

Plaintiffs own approximately 54,000 shares of a series of preferred stock issued by defendant Superior Well Services, Inc. Unlike Superior's common stock, the preferred stock carries no voting rights, but it does confer some special benefits. Among them is a requirement that Superior repurchase the preferred stock at a price of $1,000 per share (plus accrued dividends) in the event that a "fundamental change" occurs.

The document that governs the rights and obligations of the parties sets forth five scenarios that qualify as a fundamental change, two of which are relevant in this case:

> "(i) a 'person' or 'group' within the meaning of Section 13(d)(3) of the [Securities and] Exchange Act becomes the direct or indirect 'beneficial owner,' as defined in Rule 13d-3 under the Exchange Act, of shares of the Common Stock or other capital stock of the Corporation [i.e., Superior] representing more than 50% of the voting power of the Common Stock . . .; provided that this clause . . . shall not apply to a transaction covered in clause (iii) below, including any exception thereto; or . . .
>
> (iii) the Corporation merges or consolidates with or into any other Person, or any Person merges with the Corporation, other than a merger, consolidation or other transaction in which . . . the Corporation is the surviving entity."

Stated more plainly, subdivision (i) provides that a fundamental change is established if a designated entity controls more than half of the voting power of Superior's common stock, unless that occurs via a transaction listed in subdivision (iii). Subdivision (iii), in turn, directs that a merger or consolidation of Superior with or into another company (or vice versa) constitutes a fundamental change, but not if Superior is "the surviving entity" following the merger, consolidation or transaction. Thus, in this case, the preferred stockholders would be entitled to $1,000 per share if an entity acquired more than 50% of Superior's common stock, unless such acquisition was the result of a merger with another company and Superior remained the surviving entity after the transaction.

In 2010, Superior entered into an "agreement and plan of merger" with Nabors Industries Ltd. and its wholly-owned subsidiary, Diamond Acquisition Corp., which was created for the sole purpose of facilitating the acquisition of Superior. According to the agreement, Nabors would use Diamond to make a tender offer of approximately $22 for each share of Superior's common stock. Once Diamond acquired a majority of the common stock, it would merge with Superior and then cease to exist, thereby making Nabors the majority shareholder of Superior.

When plaintiffs became aware of the agreement, they invoked the fundamental change provision and demanded that Superior repurchase their preferred stock at $1,000 per share. Superior refused to do so, claiming that the arrangement did not qualify as a fundamental change under the terms of the governing agreement. The plan was then executed: Diamond acquired over 92% of Superior's common stock; it merged into Superior; Superior liquidated the remaining common stock; Diamond went out of existence; and Nabors became the sole owner of Superior.

Plaintiffs commenced this action seeking a declaration that Superior must repurchase their shares of preferred stock because a fundamental change took place. Based on the language of the fundamental change provision, Superior moved to dismiss under *CPLR 3211* claiming that a repurchase was not required since Superior survived the merger. Plaintiffs responded that, at the very least, it was ambiguous whether the initial tender offer was covered under subdivision (i) of the fundamental change provision or whether subdivision (iii) was applicable since not one, but two, companies—Superior and Nabors—survived the merger.

Supreme Court denied Superior's motion to dismiss, concluding that at the pleading stage of the case, the fundamental change provision was subject to different interpretations. The Appellate Division reversed and dismissed the complaint, viewing Diamond's acquisition of the common stock and Superior's subsequent merger with Diamond as a single transaction from which Superior emerged as the surviving entity, triggering the exception in subdivision (iii) of the fundamental change provision (*86 AD3d 431 [1st Dept 2011]*). We granted leave to appeal (*17 NY3d 716 [2011]*) and now reverse.

II

Plaintiffs maintain that the Appellate Division should not have dismissed the complaint because there is a reasonable view that the transaction at issue was a tender offer covered by subdivision (i) of the fundamental change clause, not a merger or consolidation within the meaning of subdivision (iii); that the various steps leading to the merger were separate transactions rather than a single, integrated plan; and that, even if subdivision (iii) applies, Superior was not the sole "surviving entity" because Nabors continued to exist. Superior contends that the language of the fundamental change provision unequivocally establishes that the company is not obligated to repurchase the preferred shares and, hence, it is entitled to dismissal of the complaint.

When a court rules on a *CPLR 3211* motion to dismiss, it "must accept as true the facts as alleged in the complaint and submissions in opposition to the motion, accord plaintiffs the benefit of every possible favorable inference and determine only whether the facts as alleged fit within any cognizable legal theory" (*Sokoloff v. Harriman Estates Dev. Corp., 96 NY2d 409, 414 [2001]*). The motion may be granted if "documentary evidence utterly refutes [the] plaintiff's factual allegations" (*Goshen v. Mutual Life Ins. Co. of N.Y., 98 NY2d 314, 326 [2002]*), thereby "conclusively establishing a defense as a matter of law" (*id.*, citing *Leon v. Martinez, 84 NY2d 83, 88 [1994]*). One example of such proof is an unambiguous contract that indisputably undermines the asserted causes of action (see generally *Greenfield v. Philles Records, 98 NY2d 562, 569-570 [2002]*).

In our view, Superior has failed to establish entitlement to dismissal of the complaint. Considering the language of the preferred stock agreement and construing the allegations in the light most favorable to plaintiffs, there is a reasonable basis to believe that plaintiffs may be able to establish that the fundamental change clause was activated. With regard to subdivision (i) of the provision, it is undisputed that Diamond acquired more than 50% of Superior's common stock. Standing alone, this would certainly constitute a fundamental change unless the exception described in subdivision (iii) applies. Because the use of the term "transaction" is not defined in

the preferred stock agreement, the precise meaning that the parties intended to ascribe to that terminology cannot be clearly discerned at this early point in the litigation. It could reasonably refer to (1) only the tender offer that Diamond used to secure majority control of Superior; (2) the offer and the merger of Diamond into Superior; or (3) the offer, the merger and the dissolution of Diamond. The distinction is meaningful because if the offer itself is viewed as the relevant transaction, it would not be deemed a merger or consolidation subject to subdivision (iii), meaning that a fundamental change occurred under subdivision (i) and Superior must repurchase plaintiffs' preferred stock at the agreed contract price.

Even if the entire series of steps that culminated in Nabors ownership of Superior can be considered a single, integrated transaction, plaintiffs reasonably contend that a fundamental change occurred under subdivision (iii) since Superior may not have been "the surviving entity" of the merger. Use of the word "the" tends to suggest that Superior must be the only corporate entity that remains after a merger, yet Nabors survived as well. Superior did not establish, as a matter of law, that only two of the steps in the merger plan (the tender offer and the merger of Diamond into Superior) constituted the relevant "transaction" for purposes of "the surviving entity" language in subdivision (iii). Superior's theory is plausible, but so is plaintiffs' assertion that Nabors should not be excluded from the "transaction" analysis. Consequently, the Appellate Division erred when it adopted Superior's view in the context of a *CPLR 3211* motion to dismiss.

We therefore conclude that, under the facts presented, there is ambiguity in the interpretation and effect of the preferred stock agreement and, as such, Superior is not entitled to dismissal of plaintiffs' complaint.

Accordingly, the order of the Appellate Division should be reversed, with costs, and the complaint reinstated.

Chief Judge Lippman and Judges Ciparick, Read, Smith, Pigott and Jones concur.

Chapter 5

CONVERTIBLE SECURITIES

§ 5.04 PROVISIONS RELATING TO CONVERTIBLE SECURITIES

Page 504: add the following above § 5.05

[F] Conforming Amendment Provisions

AG ONCON, LLC v. LIGAND PHARMACEUTICALS, INC.
Delaware Chancery Court C.A. No. 2018-0556 May 24, 2019
Affirmed 224 A.3d 963 (Del. 2020)

LASTER, V.C.

The plaintiffs hold convertible notes issued by defendant Ligand Pharmaceuticals Inc. Ligand sold the notes in underwritten private placements based on disclosures in an offering memorandum. At closing, Ligand entered into an indenture to govern the notes.

The indenture authorized Ligand to conform its terms to the description of the notes in the offering memorandum. Three-and-a-half years after issuing the notes, Ligand invoked this right to [change the conversion formula in the indenture].

The offering memorandum explained that the conversion value of the notes would depend on . . . the value-weighted average price of Ligand's stock on each day of a fifty-trading-day observation period. The offering memorandum stated that for each trading day, the conversion value would be [determined by applying a conversion formula].

Unfortunately, the indenture used [an erroneous] conversion formula. Exercising its right to conform the terms of the indenture to the offering memorandum, Ligand unilaterally amended the Indenture by replacing that [erroneous indenture formula] with [the conversion formula set forth in the offering memorandum].

The plaintiffs are sophisticated bond traders who purchased the notes in the secondary market. In this lawsuit, they seek to invalidate the amendment and enforce the conversion formula as it originally appeared in the indenture. The relief they seek would give them munificent returns. The notes Ligand issued have a face value of $245 million. Four years after issuance [of the notes] the plaintiffs claim [that by applying the conversion formula originally contained in the indenture] they are entitled to conversion consideration amounting to $4 billion.

According to the plaintiffs, Ligand's exercise of its right to conform the terms of the indenture to the description of the notes in the offering memorandum improperly elevated the offering memorandum over the indenture. They also say that the change contravened restrictions on Ligand's ability to amend the indenture and violated the requirements of the Trust Indenture Act [of 1939] Ligand moved to dismiss the complaint for failure to state a claim. This decision grants Ligand's motion.

I. FACTUAL BACKGROUND

The facts are drawn from the complaint and the documents it incorporates by reference. At this stage of the proceedings, the complaint's allegations are assumed to be true. The plaintiffs also receive the benefit of all reasonable inferences, including inferences drawn from documents.

A. The Offering Memorandum

In August 2014, Ligand sought to raise capital through underwritten private placements of 0.75% Convertible Senior Notes. A convertible note is a debt instrument that is convertible into shares of the issuer's stock at a specified conversion rate. The conversion rate is determined when the notes are issued. The conversion feature is "in the money" when the value of the shares that would be received upon conversion exceeds the value of the note as a debt instrument.

Ligand and its underwriters marketed the notes through a confidential offering memorandum dated August 12, 2014 . . . . (the "Offering Memorandum" or "OM"). In a thirty-one-page section titled "Description of the Notes," the Offering Memorandum described the consideration that the holder of a note would receive in various scenarios. The Offering Memorandum explained that the conversion rate for a note with a principal amount of $1,000 was 13.3251, meaning that a $1,000 note could be converted into 13.3251 shares of Ligand common stock (assuming all of the requirements for conversion were met). To protect the conversion value in the event of changes to Ligand's capital structure, the conversion rate was subject to adjustment for transactions that would affect the ownership percentage reflected by 13.3251 shares, such as issuances of new shares, stock splits, warrant distributions, or self-tenders. Generally speaking, the adjustments would ensure that the conversion rate generates a number of shares that [would be] equivalent in value to 13.3251 shares under Ligand's capital structure as it existed when the notes were issued.

From the noteholders' standpoint, the conversion rate of 13.3251 meant that the conversion feature would be in the money when the value of 13.3251 shares of Ligand common stock exceeded $1,000. The Offering Memorandum explained that the conversion rate was "equivalent to an initial conversion price of approximately $75.05 per share of our common stock.". . . . Once the value of Ligand's stock crossed that threshold, then the conversion feature would be more valuable than the debt instrument . . . .

B. The Indenture

After the underwriters had lined up purchasers, Ligand closed the offering. The closing took place on April 18, 2014, four days after the issuance of the Offering Memorandum. At closing, Ligand entered into an indenture to govern the notes . . . . . (the "Indenture" or "Ind."). In the aggregate, the notes issued under the Indenture had a face value of approximately $245 million in principal.

The Indenture reflected the same initial conversion rate as the Offering Memorandum: "[A] Holder shall have the right, . . . to convert the principal amount of its Notes, . . . at a

conversion rate initially equal to 13.3251 shares of the Common Stock . . . per $1,000 principal amount of Notes." . . . § 10.01(a) . . .

But the conversion formula in the Indenture [erroneously and substantially] differed from the conversion formula in the Offering Memorandum . . .

C. The Conversion Formula Amendment

After Ligand completed the private placements, the notes traded in the secondary markets. During this period, Ligand's public filings described the conversion formula for the notes in a manner consistent with the Offering Memorandum . . . .

[When the drafting mistake in the Indenture was discovered, Ligand conformed the conversion formula in the Indenture to the description of the conversion formula in the Offering Memorandum. This is hereafter referred to as the "Conversion Formula Amendment."] When doing so, Ligand relied on a section in the Indenture which authorizes Ligand to amend the Indenture to conform its terms to the Description of the Notes in the Offering Memorandum. *See* . . . . § 9.01(b).

D. This Litigation

The plaintiffs bought their notes in market transactions. In total, they acquired notes having a principal amount of approximately $212 million, representing 95% of the issued and outstanding notes. The plaintiffs contend that they acquired the notes because of the conversion formula in the Indenture. They claim that upon conversion, based on that formula, they would be entitled to consideration worth approximately $3.8 billion.

On July 27, 2018, the plaintiffs filed this action. The operative complaint asserts that the Conversion Formula Amendment improperly elevated the Offering Memorandum over the Indenture as the controlling document, breached the terms of the Indenture, and violated Section 316(b) of the Trust Indenture Act. The complaint seeks declaratory judgments invalidating the Conversion Formula Amendment. The complaint also seeks damages and an award of attorneys' fees. Ligand moved to dismiss pursuant to Rule 12(b)(6) for failure to state a claim on which relief can be granted.

II. LEGAL ANALYSIS

When considering a motion to dismiss for failure to state a claim, this court (i) accepts as true all well-pleaded factual allegations in the complaint, (ii) credits vague allegations if they give the opposing party notice of the claim, and (iii) draws all reasonable inferences in favor of the plaintiffs. *Savor, Inc. v. FMR Corp.*, *812 A.2d 894, 896-97 (Del. 2002)*. In applying this standard, "dismissal is inappropriate unless the plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances susceptible of proof." *Id.* (internal quotation marks omitted).

Section 9.01(b) of the Indenture states that Ligand "may amend . . . this Indenture or the Notes without the consent of any Holder to: . . . conform the terms of this Indenture or the Notes to the 'Description of the Notes' section of the Offering Memorandum." Ind. § 9.01(b) (the "Conforming Amendment Provision"). The Conversion Formula Amendment conformed the terms

of the conversion formula in the Indenture to the terms set out in the Description of the Notes section of the Offering Memorandum. Ligand contends that it validly adopted the Conversion Formula Amendment by exercising its right under the Conforming Amendment Provision.

In this litigation, the plaintiffs advance three claims as to why the Conversion Formula Amendment could not have had this effect. First, they claim that the Indenture constituted the complete and final agreement governing the notes such that Ligand could not rely on the Offering Memorandum when effectuating the Conversion Formula Amendment. Second, they argue that the Conversion Formula Amendment breached provisions of the Indenture that foreclose material and adverse amendments to the terms of the notes without noteholder consent. Third, they argue that the Conversion Formula Amendment violated the Trust Indenture Act.

A. The Complete Agreement Claim

The plaintiffs first claim that the Indenture represented the complete and final agreement governing the notes, such that Ligand could not subsequently rely on the Offering Memorandum to implement the Conversion Formula Amendment. The problem with this argument is that the Indenture itself contained the Conforming Amendment Provision, which allowed Ligand to conform the Indenture to the Offering Memorandum. This right does not depend on any language or document outside of the Indenture. It is part of the Indenture itself.

When advancing this argument, the plaintiffs observe that the Offering Memorandum recited that it was subject to the terms of the Indenture. They quote the following passage:

> **We will issue the notes under an indenture (the "indenture"),** to be entered into upon the closing of this offering, between us and Wilmington Trust, National Association, as trustee (the *"trustee"*). The terms of the notes include those expressly set forth in the indenture and those made part of the indenture by reference to certain provisions of the Trust Indenture Act of 1939, as amended (the *"Trust Indenture Act"*). You may request a copy of the indenture, which includes the form of the notes, from us. *See "*Where You Can Find More Information.*"*
>
> The following description is a summary of the material provisions of the notes and the indenture and does not purport to be complete. This summary is subject to, and is qualified by reference to, all of the provisions of the notes and the indenture, including the definitions of certain terms used in the notes and the indenture. We urge you to read these documents because they, and not this description, define your rights as a holder of the notes.

OM at 23 (emphasis added). This argument does not present any problem for Ligand because the Indenture itself contains the Conforming Amendment Provision. Ligand is not relying on any rights outside the Indenture. The Conforming Amendment Provision is one of the terms of the Indenture, and it permits Ligand to amend the Indenture to conform its terms to the Description of the Notes. Once amended, those terms became part of the Indenture. At no time did Ligand rely on any terms outside of the Indenture.

Along similar lines, the plaintiffs cite the common law rule that when an indenture and its prospectus conflict, "the indenture controls."[61] Based on this proposition, they contend that when Ligand executed the Indenture, that document became binding and superseded the Offering Memorandum. As a result, the plaintiffs say, Ligand cannot subsequently rely on the Offering Memorandum. This version of the argument suffers from the same logical flaw as its prior incarnation: Ligand is not relying on the terms of the Offering Memorandum. It is relying on the terms of the Indenture, which included the Conforming Amendment Provision and permitted Ligand to effectuate the Conversion Formula Amendment. At all times and for all purposes, Ligand has relied on the terms of the Indenture, not the Offering Memorandum.

The plaintiffs further rely on Section 8-202(a) of the New York Uniform Commercial Code, which limits the terms of a certificated security to the terms stated "on the certificate and terms made part of the security by reference on the certificate to another instrument, indenture, or document or to a constitution, statute, ordinance, rule, regulation, order, or the like, to the extent the terms referred to do not conflict with terms stated on the certificate." N.Y. U.C.C. § 8-202(a). The plaintiffs argue that the global certificate issued for the notes only referenced the Indenture and did not reference the Offering Memorandum. Therefore, they say, Ligand could not conform the Indenture to the Offering Memorandum, because that would "conflict with the terms stated on the certificate." But the certificate refers to the Indenture, which contains the Conforming Amendment Provision. Ligand's reliance on the Conforming Amendment Provision is thus consistent with the terms stated on the certificate.

B. The Material And Adverse Amendment Claim

The plaintiffs next claim that the Conversion Formula Amendment materially and adversely amended the noteholders' rights without their consent in violation of Sections 6.07 and 9.02 of the Indenture. The plaintiffs assert that Ligand cannot rely on the Conforming Amendment Provision, because that provision must be read in conjunction with Sections 6.07 and 9.02. As the plaintiffs interpret these provisions, they prohibit Ligand from using the Conforming Amendment Provision for amendments that would materially and adversely affect the noteholders' rights. Ligand responds that the Conforming Amendment Provision means what it says and permits any amendment necessary to conform the Indenture to the Offering Memorandum. This decision agrees with Ligand.

"[T]he proper interpretation of language in a contract is a question of law. Accordingly, a motion to dismiss is a proper framework for determining the meaning of contract language." *Allied Capital Corp. v. GC-Sun Hldgs., L.P.*, *910 A.2d 1020, 1030 (Del. Ch. 2006) (Strine, V.C.)*. "When deciding such a motion, however, the Court may not choose between two opposing interpretations if both interpretations are reasonable." *MCG Capital Corp. v. Maginn*, *2010 WL 1782271, at *8 (Del. Ch. May 5, 2010)*. "When the language of a contract is plain and unambiguous, binding effect should be given to its meaning." *Allied Capital*, *910 A.2d at 1030*.

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[61] *In re W.T. Grant Co.*, 4 B.R. 53, 73 (Bankr. S.D.N.Y. 1980); *see Bank of N.Y. v. BearingPoint, Inc.*, 824 N.Y.S.2d 752, at *8 (N.Y. Sup. Ct. 2006) (TABLE); *M & T Bank Corp. v. LaSalle Bank Nat'l Ass'n*, 852 F. Supp. 2d 324, 331-34 (W.D.N.Y. 2012); *see also In re Discon Corp.*, 346 F. Supp. 839, 844 (S.D. Fla. 1971).

If the provision is ambiguous, then its proper application "is a question of fact that cannot be determined on a motion to dismiss." *Maginn*, *2010 WL 1782271, at *8*.

New York law governs the Indenture. *See* Ind. § 12.08. Under New York law, the "[i]nterpretation of indenture provisions is a matter of basic contract law." *Sharon Steel Corp. v. Chase Manhattan Bank,* N.A., 691 F.2d 1039, 1049 (2d Cir. 1982). When interpreting a contract, "[t]he court should examine the entire contract and consider the relation of the parties and the circumstances under which it was executed." *William C. Atwater & Co., Inc. v. Panama R.R. Co.*, *159 N.E. 418, 419 (N.Y. 1927)*. "Particular words should be considered, not as if isolated from the context, but in light of the obligation as a whole and the intention of the parties as manifested thereby." *Id. at 419*; accord *Kass v. Kass*, *696 N.E.2d 174, 180-81 (N.Y. 1998)*; *Riverside S. Planning Corp. v. CRP/Extell Riverside, L.P.*, *920 N.E.2d 359, 363 (N.Y. 2009)*. "Ambiguity is determined by looking within the four corners of the document, not to outside sources." *Kass*, *696 N.E.2d at 180*.

In this case, reading the Indenture as a whole establishes that Ligand could rely on the Conforming Amendment Provision to effectuate the Conversion Formula Amendment. The Indenture's terms recognize that the Description of the Notes section in the Offering Memorandum established the baseline terms for the notes. In the Conforming Amendment Provision, the Indenture authorizes any amendments necessary to conform the Indenture to those baseline terms. Other provisions in the Indenture restrict amendments that would depart from the baseline terms. These provisions limit midstream amendments. They do not apply to amendments necessary to conform the Indenture to the baseline terms set forth in the Offering Memorandum.

Article Nine of the Indenture reflects this structure. It divides types of amendments into two categories: those that do not require noteholder consent and those that do. In Section 9.01, the Indenture identifies the former. In Section 9.02, the Indenture identifies the latter.

The subparts of Section 9.01 identify amendments that would preserve the original terms of the deal as marketed or facilitate compliance with those terms. In addition to the Conforming Amendment Provision, Ind. § 9.01(b), the amendments authorized by Section 9.01 include the following:

- "cure any ambiguity, omission, defect or inconsistency in the Indenture or in the Notes in a manner that does not adversely affect the rights of any Holder in any material respect," *id.* § 9.01(a);
- "make provision with respect to the conversion rights of the Holders in accordance with Section 10.06 hereof," *id.* § 9.01(c);
- "provide for the assumption by a successor corporation of the Company's obligations under this Indenture," *id.* § 9.01(d);
- "add guarantees with respect to the Notes," *id.* § 9.01(e);
- "make any change that does not adversely affect the rights of any Holder," *id.* § 9.01(h); and

- "comply with the rules of any applicable securities depositary," *id.* § 9.01(j).

In each case, the purpose of the amendment is to fulfill the original terms of the notes.

Section 9.02 provides generally that all other amendments require "the written consent of the Holders of at least a majority in aggregate principal amount," but excepts a list of specific amendments that require "the consent of each affected Holder." Each of these amendments would alter a financial term of the original deal. The list includes amendments that would:

- "reduce the rate of or extend the stated time for payment of interest," *id.* § 9.02(b); "reduce the principal amount," *id.* § 9.02(c);
- "extend the Maturity Date," *id.*;
- "make any change that impairs or adversely affects the conversion rights of any Notes," *id.* § 9.02(d);
- "make any Note payable in a [different] currency," *id.* § 9.02(f); or
- "impair the right of any Holder to receive payment of the principal . . . of, and
- interest . . . on, such Holder's Notes on or after the due dates therefor," *id.* § 9.02(h).

In each case, the amendment would alter the original terms of the notes.

To contend that Ligand could not implement the Conversion Formula Amendment, the plaintiffs rely on Section 9.02(d), which requires the consent of every affected holder for "any change that impairs or adversely affects the conversion rights of any Notes under Article 10 hereof." *Id.* § 9.02(d). According to the plaintiffs, this section qualifies the Conforming Amendment Provision to mean that Ligand can only make conforming amendments that do not "impair [ ] or adversely affect[ ] the conversion rights."

Nothing in Section 9.02(d) suggests that it trumps the Conforming Amendment Provision or operates "notwithstanding" other sections of the Indenture. This is significant because when the drafters of the Indenture wanted to make one section of the Indenture supersede other sections, they used the preposition "notwithstanding" to signal that expressly.[62] Likewise, nothing in the Conforming Amendment Provision makes it subject to Section 9.02(d) or limits its operation to amendments that do not impair or adversely affect the noteholders' conversion rights. Here too, when the drafters wanted to limit the power to amend, they did so expressly.[63] By not introducing these qualifiers, the drafters of the Indenture indicated that the Conforming Amendment Provision would operate independently and on its own terms. *See Quadrant Structured Prods. Co. v. Vertin*, *23 N.Y.3d 549, 560 (2014)* ("[I]f parties to a contract

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[62] *See, e.g., id.* §§ 2.06(b), 2.12(a), 2.12(d)(i), 2.12(e), 2.14, 3.10(a), 3.11, 3.12, 4.02(a), 4.02(d), 4.02(e), 5.01(b), 6.01(a), 6.01(c), 6.07, 7.02(n), 10.03(b), 10.03(c), 10.04(c)(i), 10.04(c)(ii), 10.04(f), 10.04(j), 10.07(c), 10.07(d).

[63] *See, e.g., id.* § 9.01(a) (limiting permitted amendments to those that do "not adversely affect the rights of any Holder in any material respect"); *id.* § 9.01(h) (permitting amendments that do "not adversely affect the rights of any Holder").

omit terms—particularly, terms that are readily found in other, similar contracts—the inescapable conclusion is that the parties intended the omission.").

And this makes sense, because the Conforming Amendment Provision and Section 9.02(d) serve different purposes. The Conforming Amendment Provision ensures that the terms of the Indenture match the original terms of the deal as marketed in the Offering Memorandum. Although nominally styled as an "amendment" for purposes of Section 9.01(b), invoking the Conforming Amendment Provision does not amend the deal at all. It maintains the original deal by conforming the terms of the Indenture to the original terms. Section 9.02(d), by contrast, serves a different purpose. It prohibits departures from the original deal unless every affected noteholder consents. Unlike the Conforming Amendment Provision, Section 9.02(d) governs true midstream amendments.

The Conversion Formula Amendment fell within the scope of the Conforming Amendment Provision. It did not amend the original deal; it preserved it by conforming the language of the Indenture to the marketed terms. If Ligand had attempted to depart from the original deal, then Section 9.02(d) would have applied and required noteholder consent.

In a related argument, the plaintiffs assert that the Conversion Formula Amendment contravened Section 6.07, which limits the ability of Ligand to amend the Indenture in a manner that would adversely affect the noteholders' ability to bring suit to enforce their payment rights. Section 6.07 states:

> Notwithstanding any other provision of the Indenture, the right of any Holder to bring suit for the enforcement of payment of principal, accrued and unpaid interest (including Additional Interest and Special Interest), if any, or payment of the Fundamental Change Purchase Price on or after the respective due dates, or the right to receive consideration due upon conversion of Notes in accordance with Article 10, shall not be impaired or affected without the consent of such Holder . . .

Ind. § 6.07. Unlike Section 9.02(d), Section 6.07 uses the preposition "notwithstanding," so it would trump the Conforming Amendment Provision. But Section 6.07 does not apply to a change in the conversion formula; it protects the right to bring suit.

The provisions of the Indenture that protect against changes to the amount of principal, interest, and conversion consideration are found in Sections 9.02(b), (c), and (d). Read in conjunction with the Conforming Amendment Provision, these sections state that Ligand cannot make any adverse change in the amount of principal, interest, or conversion consideration without obtaining consent from each adversely affected holder, except to conform the Indenture to the original deal set forth in the Offering Memorandum. Section 6.07 provides a different form of protection. It protects the noteholders' "right . . . to bring suit for the enforcement of" their economic rights. In other words, it protects the right to sue, not the underlying economic right. *See* Am. Bar Ass'n, Revised Model Simplified Indenture, 55 Bus. Law. 1115, 1215 (2000) ("Section 6.07 prescribes that each Securityholder's right to sue to enforce the conversion privilege may not be impaired or affected without such holder's consent."). Section 6.07 thus

does not independently protect the conversion rights from amendment, and it is inapplicable here.

Under the Conforming Amendment Provision, Ligand exercised its right to conform the terms of the Indenture to the description of the notes in the Offering Memorandum. That is all that the Conversion Formula Amendment did, so Ligand was authorized to implement it without noteholder consent. If Ligand had tried to make any other changes in the noteholders' conversion rights, then Section 9.02(d) would have applied and required consent from each adversely affected noteholder. But Ligand only made conforming changes, which it was authorized to do. The plaintiffs have therefore failed to state a claim that the Conforming Amendment Provision violated the Indenture.

C. The Trust Indenture Act

Last, the plaintiffs argue that the Conversion Formula Amendment violated Section 316(b) of the Trust Indenture Act, which states:

> Notwithstanding any other provision of the indenture to be qualified, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder except as to a postponement of an interest payment consented to as provided in paragraph (2) of subsection (a), and except that such indenture may contain provisions limiting or denying the right of any such holder to institute any such suit, if and to the extent that the institution or prosecution thereof or the entry of judgment therein would, under applicable law, result in the surrender, impairment, waiver, or loss of the lien of such indenture upon any property subject to such lien.

15 U.S.C. § 77ppp(b). According to the plaintiffs, Section 316(b) prohibited Ligand from unilaterally amending their conversion rights. This argument fails because Section 316(b) does not apply to the Indenture. The plaintiffs respond that the terms of the Indenture nevertheless voluntarily incorporated the restrictions imposed by Section 316(b), but the language of the Indenture does not support their argument. Regardless, Section 316(b) would not prohibit the Conversion Formula Amendment.

1. Section 316(b) Does Not Apply To The Indenture.

Section 316(b) does not apply to the Indenture because the Indenture was not an "indenture security" for purposes of the Trust Indenture Act. As quoted above, Section 316(b) protects "the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security . . . ." Id. § 77ppp(b) (emphasis added). The Trust Indenture Act defines the term "indenture security" to mean "any security issued or issuable under the indenture to be

qualified." Id. § 77ccc(11). An "indenture to be qualified" is defined as "(A) the indenture under which there has been or is to be issued a security in respect of which a particular registration statement has been filed, or (B) the indenture in respect to which a particular application has been filed." Id. § 77ccc(9).

The Indenture was not an "indenture to be qualified" under prongs (A) or (B). The complaint recognizes that Ligand never filed a registration statement and never applied for qualification. In fact, Ligand stated in the Offering Memorandum that "we do not currently intend to seek such qualification." Ind. at 49.

In response, the plaintiffs imply that that the Indenture *should have been* qualified under the Trust Indenture Act, and therefore Section 316(b) applies. This argument fails because the Indenture was exempt from the Trust Indenture Act's qualification requirements.

A complex set of provisions gives rise to the qualification requirements for nonpublicly offered securities. The starting point is Section 307 of the Trust Indenture Act, which states:

> In the case of any security which is not required to be registered under the Securities Act of 1933 and to which subsection (a) of section 77fff of this title [*i.e.*, Section 306] is applicable notwithstanding the provisions of section 77ddd of this title [*i.e.*, Section 304], an application for qualification of the indenture under which such security has been or is to be issued shall be filed with the Commission by the issuer of such security.

15 U.S.C. § 77ggg(a). Section 307 thus frames the qualification requirement in terms of whether the security is one "to which subsection (a) of Section 306 is applicable notwithstanding the provisions of Section 304." Examining Sections 306(a) and 304 of the Trust Indenture Act shows that the latter is the important provision. Rather than addressing what securities must be qualified, Section 306(a) prohibits any person from using means of interstate commerce to disseminate, sell, or convey a security "which is not registered under the Securities Act of 1933 and to which this subsection is applicable notwithstanding the provisions of section 77ddd of this title [*i.e.,* Section 304]." *Id.* § 77fff(a). Section 304, by contrast, addresses the universe of securities that must be qualified by specifying a list of exemptions. Section 304(a) exempts certain special securities from the Trust Indenture Act in its entirety.[64] Section 304(b) provides a narrower exemption from Sections 305 and 306 of the Trust Indenture Act for:

> (1) any of the transactions exempted from the provisions of section 5 of the Securities Act of 1933 by section 4 thereof, or
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> (2) . . . any transaction which would be so exempted but for the last sentence of paragraph (11) of section 2(a) of such Act.

[64] *See, e.g., id.* § 77ddd(a)(4) (exempting "(A) any security exempted from the provisions of the Securities Act of 1933 by paragraph (2) to (8), (11), or (13) of section 3(a) thereof; (B) any security exempted from the provisions of the Securities Act of 1933, as amended, by paragraph (2) of subsection 3(a) thereof, as amended by section 401 of the Employment Security Amendments of 1970").

Id. § 77ddd(b) (formatting added). The transactions covered by part (1) of this exemption include "transactions by an issuer not involving any public offering." *Id.* § 77d(a)(2).

We thus reach the endpoint: A transaction not involving a public offering is not subject to qualification.[65] Ligand's issuance did not involve a public offering, so it was exempt from the Trust Indenture Act under Sections 304(b), 306, and 307. The Indenture was therefore not an "indenture security," and it was not subject to Section 316(b).

2. The Agreement Does Not Incorporate The Entire Trust Indenture Act.

The plaintiffs respond that the drafters of the Indenture chose to incorporate the terms of the Trust Indenture Act, making Section 316(b) applicable even though it otherwise would not apply. For support they rely on Section 9.06 of the Indenture, which states: "Every supplemental indenture executed pursuant to this Article shall comply with the [Trust Indenture Act]." This one provision does not do the trick. Instead, the language of the Indenture, read as a whole, evidences an intention to incorporate only specific provisions of the Trust Indenture Act.

Section 1.01 of the Indenture defines the "Indenture" as "this Indenture, as amended or supplemented from time to time in accordance with the terms hereof, including the provisions of the [Trust Indenture Act] that are deemed to be a part hereof." Consistent with this definition, Section 1.03 of the Indenture explains that "[w]henever this Indenture refers to a provision of the [Trust Indenture Act], the provision is incorporated by reference in and made a part of this Indenture." As suggested by this language, various provisions in the Indenture refer to and incorporate specific sections of the Trust Indenture Act.[66] In some instances, the provision in the

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[65] *See Abbate v. Wells Fargo Bank, N.A.*, *2011 WL 13128742, at *4 (C.D. Cal. Apr. 25, 2011)* ("[T]he TIA does not govern private placements . . . ."); *In re Magnatrax Corp., 2003 WL 22807541, at *15 (D. Del. Nov. 17, 2003)* (holding that notes offered in private placement were "exempt from the TIA by virtue of Section 304(b)"). This is a slight overstatement. There are two special types of issuances that still require qualification, but neither is present here. *See generally* James Gadsden, *Introduction to the Annotated Trust Indenture Act*, *67 Bus. Law. 979, 1054 (2012)* (explaining the relationship between Sections 304, 306, and 307 and citing legislative history in support of the conclusion that the Trust Indenture Act only applies to registered offerings, except for "(a) indenture securities issued in exchange for other securities of the same issuer, and (b) indenture securities issued in connection with a judicial reorganization").

[66] *See, e.g.*, Ind. § 4.02(a) ("The Company shall comply with the other provisions of TIA Section 314(a)."); *id.* § 7.06 ("Within 120 days of each December 31, commencing on December 31, 2014, and for so long as any notes remain outstanding, the Trustee shall mail to each Holder a brief report dated as of December 31 of such year that complies with TIA Section 313(a), if and to the extent required by such subsection. The Trustee shall also comply with TIA Section 313(b). The Trustee will also transmit by mail all reports as required by TIA 313(c)."); *id.* § 7.10 ("The Trustee shall at all times satisfy the requirements of TIA Section 310(a)."); *id.* § 7.11 ("A Trustee who has resigned or been removed shall be subject to TIA Section 311(a) to the extent indicated therein."); *id.* § 12.03 ("Holders may communicate pursuant to TIA Section 312(b) with other Holders with respect to their rights under this Indenture or the Notes. The Company, the Trustee, the Registrar, the Paying Agent, the Conversion Agent and anyone else shall have the protection of TIA Section 312(c).").

Indenture modifies how the section of the Trust Indenture Act will operate when incorporated into the Indenture.[67]

The Indenture never incorporates the Trust Indenture Act as a whole, nor does it incorporate Section 316(b). Section 9.06, on which the plaintiffs rely, does not do so either. Instead, it generally states that any supplemental indenture "shall comply with the [Trust Indenture Act]." To avoid inconsistencies with other references in the Indenture to specific sections of the Trust Indenture Act, Section 9.06 must mean that any supplemental indenture shall comply with the Trust Indenture Act to the same extent as the original indenture. It ensures that any supplemental indenture will be subject to the same specific sections of the Trust Indenture Act and the same modifications to the application of those sections. It does not incorporate the Trust Indenture Act as a whole and hence does not bring with it the strictures of Section 316(b).

3. Even If Section 316(b) Applied, It Would Not Prohibit The Conversion Formula Amendment.

Finally, even if Section 316(b) applied to the Indenture, it would not prohibit the Conversion Formula Amendment. The plain language of Section 316(b) states that it protects "the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security . . . ." 15 U.S.C. § 77ppp(b). The plain language of Section 316(b) does not extend to consideration received under a conversion right.

Although this court has not ruled on this issue, then-Chancellor Strine observed in *dictum* that conversion rights are not covered by Section 316(b). See *RBC Capital Mkts., LLC v. Educ. Loan Tr. IV, 2011 WL 6152282, at *5, *6 n. 36 (Del. Ch. Dec. 6, 2011) (Strine, C.)* ("An exception to no-action clauses for the enforcement of conversion rights, unlike the exception for enforcement of principal and interest payments, is not mandated by [Section 316(b) of] the Trust

[67] *See, e.g., id.* § 7.10 ("The Trustee shall comply with TIA Section 310(b), subject to the penultimate paragraph thereof; provided, however, that there shall be excluded from the operation of TIA Section 310(b)(1) any indenture or indentures under which other securities or certificates of interest or participation in other securities of the Company are outstanding if the requirements for such exclusion set forth in TIA Section 310(b)(1) are met."); *id.* § 7.11 ("The Trustee shall comply with TIA Section 311(a), excluding any creditor relationship listed in TIA Section 311(b).").

Indenture Act . . . . ”). The model indentures promulgated by the American Bar Association often protect these rights, but the Trust Indenture Act does not.[68]

To expand the scope of Section 316(b) beyond its plain language, the plaintiffs quote a series of cases which state that Section 316(b) protects the *“*core terms*”* or *“*payment terms*”* of an indenture. But these general observations are qualified by references to the noteholders*’* right to receive payment of principal and interest.[69] The most expansive reading of the *“*core terms*”* protected by Section 316(b) encompasses the timing of payments of principal and interest.[70] No court has held that Section 316(b) protects the consideration that a noteholder would receive upon exercising a conversion right. As a result, Section 316(b) would not prevent the Conversion Formula Amendment even if it applied to the Indenture.

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[68] *See id.* at *6 n.36; *see also,* William W. Bratton & Adam J. Levitin, The New Bond Workouts, 166 U. Pa. L. Rev. 1597, 1659 (2018) (noting that model bond indentures often contain extra-statutory protections that “pick up redemption terms, guaranties, conversion provisions, and subordination languages”); Am. Bar Found., Commentaries on Model Debenture Indenture Provisions 1965 309 (1971) (“As indicated in the Sample Incorporating Indenture quoted above, the right of conversion in a convertible issue is treated as an essential right which may not be amended without the consent of each holder affected thereby. Thus, in a convertible debenture indenture, the draftsman should add to Section 902 a clause (4) protecting such right.”); *id.* at 303 (“In the case of convertible debentures, Article 900 of the Model Provisions, as incorporated herein, should be amended by adding to the proviso in Section 902 a new clause to the effect that no supplemental indenture shall adversely affect the conversion rights of the Debentureholders under Article Thirteen. In the case of subordinated Debentures, Article Nine should contain a new § 9-7 to the effect that no supplemental indenture shall adversely affect the rights of any holder of Senior Debt under Article Fourteen without the consent of such holder.” (formatting altered)). Provisions protecting conversion rights are not universal. *See* Am. Bar Ass’n, supra, at 1138 (protecting “the right of any Holder of a Security to receive payment of Principal and interest on the Security,” but not the right to receive payment for the exercise of conversion rights).

[69] *See, e.g., Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Fin. Corp*., *846 F.3d 1, 7 (2d Cir. 2017)* (explaining that Section 316(b) “prohibits non-consensual amendments of core payment terms (that is, the amount of principal and interest owed, and the date of maturity)”); *id.* at 12 (explaining that testimony at the congressional hearings over what would become the Trust Indenture Act “made it clear that [Section 316(b)] prohibited only formal changes to an indenture’s core payment terms”); *id.* at 16 (“Limiting Section 316(b) to formal indenture amendments to core payment rights will not leave dissenting bondholders at the mercy of bondholder majorities.”); *UPIC & Co. v. Kinder-Care Learning Ctrs., Inc.*, *793 F. Supp. 448, 452 (S.D.N.Y. 1992)* (“Section 316(b) expressly prohibits use of an indenture that permits modification by majority securityholder vote of any core term of the indenture, i.e., one affecting a securityholder’s right to receive payment of the principal of or interest on the indenture security on the due dates for such payments . . . .”); *id.* at 455 (explaining that the legislative history “tends to evince Congress’ intent to have Section 316(b) interpreted so as to give effect to the absolute and unconditional nature of the right to payment it affords a Securityholder”); *Bank of N.Y. v. First Millennium, Inc.*, *607 F.3d 905, 917 (2d Cir. 2010)* (describing Section 316(b) as “a statutory provision requiring that bond indentures protect minority bondholders by prohibiting majority bondholders from collusively agreeing to modify the bond’s payment terms”); *Petrohawk Energy Corp. v. Law Debenture Trust Co. of N.Y.*, *2007 WL 211096, at *5 (S.D.N.Y. Jan. 29, 2007)* (stating that Section 316(b) prohibits “‘use of an indenture that permits modification by a majority securityholder vote of any core term of the indenture,’ such as the holder’s right to receive payment of principal or interest” (quoting UPIC, 793 F. Supp. at 452)).

[70] *See* UPIC, 793 F. Supp. at 455-56 (explaining that defendants’ failure to honor a repurchase right in an indenture would violate plaintiffs’ right to receive payment of the principal of the indenture security on or after the respective due dates expressed in such indenture security); *see also McMahan & Co. v. Wherehouse Entm’t, Inc.*, *65 F.3d 1044, 1050 n.4 (2d Cir. 1995)* (describing the right to bring suit for timely payment: “Section 8.07 of the Indenture provides that debentureholders are excused from complying with the No-Action Clause in suits based on nonpayment of principal and interest on or after the due dates expressed in the Debenture and in suits based on the right to convert a Debenture to common stock. This is a requirement of section 316(b) of the Trust Indenture Act.”).

III. CONCLUSION

The plaintiffs have failed to present a litigable challenge to Ligand's adoption of the Conversion Formula Amendment in reliance on the Conforming Amendment Provision. Ligand's motion to dismiss is granted.

§ 5.07 INTERPRETATION AND EFFECT OF ANTI-DILUTION PROVISIONS

Page 506: Add the following above Broad v. Rockwell International Corp.

The interpretation of corporate finance documents involves the application of *"*legal principles at the intersection of the law of contracts and corporate law*."* Royce de R. Barondes, Vestigial Literalism in the Interpretation of Corporate Financing Instruments, 15 *Tenn. J. of Bus. Law* 239, 240 (2014) (Footnotes omitted) suggesting *"*enhanced reference to the evident purposes manifested by the instruments taken as a whole*"* when *"*one cannot identify a plausible reason why parties would have bargained for the outcome dictated by a literal parsing of the individual provision*."* *Id. at 315.* The cases in this section illustrate the difficulties courts may confront in determining the meaning of corporate finance provisions, while at the same time adhering to precedent and thus permitting capital market participants *"*to be able to predict the consequences of their actions and the actions of those they dealt with*."*[71]

Page 537: Add the following at the end of NOTE 1

It seems difficult to square the *Parkinson* rule with state merger statutes such as Section 906(b)(3) of the New York Business Corporation Law (page 59*, supra)* as well as Section 259(a) of the Delaware General Corporation Law which provides that a corporation surviving a merger assumes by operation of law all of the *"*liabilities and duties*"* of the non-surviving corporation, which presumably include a duty to deliver securities upon exercise of a conversion privilege.

ADD A NEW (2) TO THIS NOTE – DISCUSS SUPPLEMENTAL INDENTURE ISSUES, E.G. TYCO –TEE HAS NO VETO POWER BY REFUSING TO SIGN.

Page 538: add the following above Stephenson v. Plastics Corp. of America.

KAISER ALUMINUM CORP. v. MATHESON
Delaware Supreme Court
681 A.2d 392 (1996)

VEASEY, CHIEF JUSTICE:

In this interlocutory appeal, we affirm a preliminary injunction order of the Court of Chancery enjoining the effectuation of a corporate recapitalization on the ground that the existing conversion rights of preferred stockholders cannot be adjusted as set forth in the proposed recapitalization without the consent of the preferred holders. Specifically, we hold that the

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[71] Norman S. Poser *Lord Mansfield Justice in the Age of Reason* 229 (2013). A noted Chief Judge of the New York Court of Appeals has stated that stare decisis "provides the stability and fair measure of certainty which are prime requisites in any body of law. It enables lawyers to advise their clients and permits clients to regulate their affairs, with reference to the authoritative rules of conduct that the courts may be expected to apply." John T. Loughran, *Some Reflections On The Role Of Judicial Precedent,* 22 Fordham Law Rev. 1, 3 (1953).

existing conversion rights of the preferred stockholders, as ambiguously stated in the Certificate of Designations, should be construed in favor of the preferred holders to require conversion to the common stock which existed before the recapitalization, not the new common stock resulting from the recapitalization.

Facts

Kaiser Aluminum Corporation ("Kaiser"), its directors and its controlling stockholder, MAXXAM, Inc., appeal from the grant of a preliminary injunction preventing Kaiser from implementing a recapitalization plan (the "Recapitalization"). The Recapitalization would create two classes of common stock with one class having disparate voting rights from the existing single class of common stock ("Existing Common Stock"). This result would be achieved by an amendment to the certificate of incorporation reclassifying the 100 million authorized shares of Existing Common Stock as one class of Class A Common shares ("New Class A Common") with full voting rights. The Recapitalization would also authorize the issuance of an additional 250 million shares of new, low-voting common stock ("New Common Stock") possessing voting rights of 1/10 vote per share. Current holders of Existing Common Stock will receive .33 shares of New Class A Common and .67 shares of New Common for each share of Existing Common Stock.

MAXXAM owns 50 million shares of the 71.6 million shares of Existing Common Stock currently outstanding. The Plaintiffs own shares of Preferred Redeemable Increased Dividend Equity Securities ("PRIDES") issued by Kaiser in February of 1994.[72] Kaiser has issued 8,673,850 of the 20,000,000 shares of PRIDES authorized by its Certificate of Incorporation. The PRIDES are convertible into .8333 shares of Common Stock[73] at the option of the holder prior to December 31, 1997. Between December 31, 1996 and December 31, 1997, Kaiser can redeem the PRIDES at a conversion ratio based on the market price of the Common Stock but subject to a minimum redemption value of .8333 shares of Common Stock for each share of PRIDES. On December 31, 1997, each share of PRIDES converts automatically into one share of Common Stock. The PRIDES have 4/5 vote per share and vote with the common shares.

Kaiser intends to adjust the conversion ratio for the PRIDES so that each share of PRIDES will convert on December 31, 1997 into .33 shares of New Class A Common and .67 shares of New Common. The Plaintiffs filed suit on March 19, 1996 seeking, *inter alia*, to enjoin the special stockholders' meeting scheduled for April 10, 1996 at which a vote on the Recapitalization was to be taken. The Plaintiffs asserted four claims in their complaint: (1) that

[72] One of the plaintiffs, Donald Matheson, also owns common shares of Kaiser.

[73] Since the crux of the debate between the parties is whether the PRIDES are convertible into the Common Stock as it exists prior to the proposed recapitalization (i.e., "Existing Common Stock") or in its altered, post-recapitalization form, the generic term "Common Stock" is used here in place of the term "Existing Common Stock." This terminology matches the language of the Certificate of Designations which, aside from the anomalous reference in § 3(d)(i) discussed *infra*, refers simply to "Common Stock."

the Certificate of Designations (the *"Certificate"*)[74] for the PRIDES does not permit Kaiser to change, pursuant to a reclassification, the security into which the PRIDES are convertible; (2) that Kaiser is required to procure a separate class vote of the PRIDES; (3) that the proxy statement issued in connection with the special meeting omits material facts and misstates material facts; and (4) that the Recapitalization is the result of breaches of the duties of care and loyalty owed to the Plaintiffs by the directors of Kaiser and its controlling stockholder, MAXXAM.

On April 10, 1996, the Court of Chancery issued a preliminary injunction against the consummation of the amendment to the Certificate of Incorporation but allowed the meeting and vote to proceed. The meeting was adjourned until May 1, 1996. On April 19, 1996, this Court granted the Defendants' motion for an expedited interlocutory appeal. The special meeting was held on May 1, 1996 and the proposal received the vote of a majority of outstanding shares.

* * * *

Interpretation of the Certificate

The preferences and conversion rights of the PRIDES are governed by the Certificate. *Wood v. Coastal States Gas Corp.*, *Del. Supr., 401 A.2d 932, 937 (1979)*; *Jedwab v. MGM Grand Hotels, Inc.*, *Del. Ch., 509 A.2d 584, 593 (1986)*. The Certificate is interpreted using standard rules of contract interpretation which require a court to determine from the language of the contract the intent of the parties. Waggoner, 581 A.2d at 1134. In discerning the intent of the parties, the Certificate should be read as a whole and, if possible, interpreted to reconcile all of the provisions of the document. *Warner Communications Inc. v. Chris-Craft Indus., Inc.*, *Del. Ch., 583 A.2d 962, 967, aff'd, Del. Supr., 567 A.2d 419 (1989)*.

If no ambiguity is present, the Court must give effect to the clear language of the Certificate. *Johnston v. Tally Ho, Inc., Del. Super., 303 A.2d 677, 679 (1973)*. *"*A contract is not rendered ambiguous simply because the parties do not agree upon its proper construction. Rather, a contract is ambiguous only when the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings.*"* *Rhone-Poulenc Basic Chems. Co. v. American Motorists Ins. Co., Del. Supr., 616 A.2d 1192, 1196 (1992)* (insurance contract). In this case, as in the context of the insurance contract under consideration in Rhone-Poulenc, *"*[t]he true test is not what the parties to the contract intended it to mean, but what a reasonable person in the position of the parties would have thought it meant.*"* *Id.* (citing *Steigler v. Insurance Co. of N. America, Del. Supr., 384 A.2d 398, 401 (1978)* (contracts should be read to accord with the reasonable expectations of a reasonable purchaser)). Where, as here, the ultimate purchaser of the securities is not a party to the drafting of the instrument which determines her rights, the reasonable expectations of the purchaser of the securities must be given effect.

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[74] When the Certificate of Designations became effective in February of 1994, it had the effect of amending the Certificate of Incorporation so that the rights of the preferred stockholders fixed by the Certificate became part of the Certificate of Incorporation. *8 Del. C. §§ 102(a)(4)*; 151(g).

The PRIDES are a convertible security. Accordingly, the Certificate sets forth detailed language broadly referred to as anti-dilution adjustments.[75] Such provisions protect the value of the conversion feature in the case of certain events which could otherwise reduce the value of that into which the PRIDES convert, namely the Common Stock of Kaiser.

The provision at issue is section 3(d)(i) of the Certificate, which states:

(d) *Common Equivalent Rate and Optional Conversion Rate Adjustments*.

* * * * * *

(i) If the Corporation shall either:

(1) pay a dividend or make a distribution with respect to Common Stock[76] in shares of Common Stock,

(2) subdivide or split its outstanding shares of Common Stock into a greater number of shares,

(3) combine its outstanding shares of Common Stock into a smaller number of shares, or

(4) *issue by reclassification of its shares of* **Common Stock** *any shares of* **common stock** .

then, in any such event, [the conversion rates] in effect immediately prior thereto shall each be adjusted so that the *holder of a share of PRIDES shall be entitled to receive, on the conversion of such share of PRIDES, the number of shares of Common Stock of the Corporation which such holder would have owned or been entitled to receive* after the happening of any of the events described above had such share of PRIDES been converted . . . *immediately prior to the happening of such event* . . .

(Emphasis supplied.) Kaiser contends that the provision contemplates that the PRIDES holders will receive on conversion *"*whatever new securities the holders of the underlying security received in the corporate transactions covered by those adjustment provisions.*"*

The Plaintiffs contend that the use of upper case (Common Stock) and lower case (common stock) in different parts of 3(d)(i)(4) compels the result reached below:

Section 3(d)(i)(4) clearly differentiates between two kinds of stock: (1) the *"*Common Stock*"* that is being reclassified and (2) the *"*common stock*"* that is newly issued as a result of the reclassification. The operative language of the *"*then*"* clause of the anti-dilution provision states that after such a reclassification the PRIDES still converts

[75] The issues presented by this case are not of recent origin. *See Parkinson v. West End St. Ry. Co., Sup.Jud.Ct., 173 Mass. 446, 53 N.E. 891 (1899)* (Holmes, J.) (considering rights of convertible security holders); George S. Hills, *Convertible Securities: Legal Aspects and Draftsmanship*, 19 Cal.L.Rev. 1 (1930); Richard M. Buxbaum, *Preferred Stock: Law and Draftsmanship*, 42 Cal.L.Rev. 243 (1954).

[76] Common Stock is defined as "fully paid and non-assessable shares of common stock of the Corporation." Certificate § 3(a)(i).

> into the "Common Stock" that was reclassified—whatever it is— rather than the new "common stock."

Kaiser's explanation for the use of "Common Stock" in the then clause of the Certificate is less than satisfying. Kaiser explains the use of "Common Stock" as follows:

> Why then is the term lower case "common stock" used at all in the "if" clause? The drafter was simply distinguishing between the old and the new. Prior to the effectiveness of a reclassification, the new common stock would not yet have been substituted into the conversion rate; accordingly, it would have been inappropriate to use the specific defined term from Section 3(a)(i), which dealt only with the conversion rate. The capitalized term in the "then" clause refers to the same stock, but only after it has been substituted for the old stock in the conversion rate.

The Certificate could have stated clearly the result for which Kaiser contends by drawing from the Certificate itself. It did not clearly so state. As the plaintiffs point out, section 3(e) contains the traditional language employed to achieve such a result. It states:

> (e) *Adjustment for Certain Mergers and Other Transactions*. In case of any consolidation or merger . . . each share of PRIDES shall, after consummation of such transaction, be subject to . . . conversion . . . into the kind and amount of securities, cash, or other property receivable upon consummation of such transaction by a holder of the number of shares of Common Stock into which such share of PRIDES might have been converted immediately before consummation of such transaction. . .

Other examples also illustrate the ease with which the documents governing convertible securities can express such an intent. The Model Debenture Indenture specifically treats a reclassification in such a manner:

> If any . . . reclassification of the capital stock of the Company . . . shall be effected in such a way that holders of Common Stock shall be entitled to receive stock, securities or assets with respect to or in exchange for Common Stock, then, . . . the Company . . . shall execute . . . a supplemental indenture providing that the Holder of each Debenture then Outstanding shall have the right thereafter and until the expiration of the period of convertibility to convert such Debenture into the kind and amount of stock, securities or assets receivable upon such . . . reclassification . . . by a holder of the number of shares of Common Stock into which such Debenture might have been converted immediately prior to such . . . reclassification. . .

American Bar Foundation, *Commentaries on Model Debenture Indenture Provisions*, Article Thirteen, Conversion—Sample Provisions § 13-6 (Alternate 1) (1971).

Unlike the Model Debenture Indenture, the more recent Model Simplified Indenture (the "MSI") adjusts the conversion rate in the case of a reclassification in a manner more similar to the Certificate. In fact, the Certificate bears a striking resemblance, in certain respects, to the analogous MSI provision. The MSI provides:

Section 10.06. Adjustment for Change in Capital Stock.

If the Company:

(1) pays a dividend or makes a distribution on its Common Stock[77] in shares of its Common Stock;

(2) subdivides its outstanding shares of Common Stock into a greater number of shares;

(3) combines its outstanding shares of Common Stock into a smaller number of shares;

(4) makes a distribution on its Common Stock in shares of its capital stock other than Common Stock; or

(5) issues by reclassification of its Common Stock any shares of its capital stock,

then the conversion privilege and the conversion price in effect immediately prior to such action shall be adjusted so that the Holder of a Security thereafter converted may receive the number of shares of capital stock of the Company which he would have owned immediately following such action if he had converted the Security immediately prior to such action.

The adjustment shall become effective immediately after the record date in the case of a dividend or distribution and immediately after the effective date in the case of a subdivision, combination or reclassification.

If after an adjustment a Holder of a Security upon conversion of it may receive shares of two or more classes of capital stock of the Company, the Company shall determine the allocation of the adjusted conversion price between the classes of capital stock. After such allocation, the conversion privilege and the conversion price of each class of capital stock shall thereafter be subject to adjustment on terms comparable to those applicable to Common Stock in this Article.

Model Simplified Indenture, 38 Bus.Law. 741, 765-766 (Feb.1983).

The MSI employs the term *"capital stock"* in the then clause.[78] If the Certificate used *"common stock,"* instead of *"Common Stock,"* in the then clause, the capitalization would match the MSI. Such a choice of capitalization would more clearly yield the result for which Kaiser argues since Plaintiffs could not argue that they are entitled to the existing *"Common Stock."* They would receive upon conversion whatever *"common stock"* was issued in the reclassification.

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[77] Unlike the Certificate, section 10.01 of the MSI defines Common Stock as "Common Stock of the Company as it exists on the date of this Indenture as originally signed."

[78] The Certificate uses the narrower term "common stock" to exclude reclassifications in which preferred stock is issued. Such a reclassification would, arguably, be covered by section 3(d)(iii).

Noticeably absent, as well, is a paragraph similar to the last paragraph of section 10.06 of the MSI, which specifically contemplates a dual-class reclassification. Had such a provision been present, an interpretation of the Certificate which did not allow the company to convert the PRIDES into two classes of common stock would leave that section as surplusage.

Our consideration of these alternative formulations does not mean, of course, that issuers must follow model provisions. Such models are an aid to drafting and construction. If they are borrowed verbatim by the drafters, interpretation may be enhanced, but interpretation may become problematic if the drafter excludes key language from the model provision.

Reference to such models also does not imply that the Plaintiffs' interpretation is necessarily correct or completely satisfying. The Certificate is hopelessly unclear on the very point at issue. Other efforts at anti-dilution provisions indicate, however, that the Certificate could have clearly stated the intent for which Kaiser now argues. That much is evident from widely available models and other provisions of the Certificate.

When a contract is ambiguous, a court normally relies upon extrinsic evidence of the parties' intent. Such a course is not appropriate in this case for two reasons. First, such an investigation would reveal information about the thoughts and positions of, at most, the issuer and the underwriter. Whether these parties can legitimately be viewed as "negotiating" indenture provisions is a subject of some dispute. *Compare Prescott, Ball & Turben v. LTV Corp., S.D.N.Y., 531 F.Supp. 213, 217 (1981), with Morgan Stanley & Co., Inc. v. Archer Daniels Midland Co., S.D.N.Y., 570 F. Supp. 1529, 1541 (1983)* . . . Since these sorts of provisions "are . . . not the consequence of the relationship of particular borrowers and lenders and do not depend upon particularized intentions of the parties to an indenture," evidence of the course of negotiations would not be helpful. *Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 2d Cir., 691 F.2d 1039, 1048 (1982)* . . . .

Second, we are reluctant to risk disuniformity by adverting to evidence of the course of negotiation in a setting in which the same language can be found in many different contracts. A leading case in the interpretation of indenture provisions remarks:

> Whereas participants in the capital markets can adjust their affairs according to a uniform interpretation, whether it be correct or not as an initial proposition, the creation of enduring uncertainties as to the meaning of boilerplate provisions would decrease the value of all debenture issues and greatly impair the efficient working of capital markets. Such uncertainties would vastly increase the risks and, therefore, the costs of borrowing with no offsetting benefits either in the capital market or in the administration of justice. Just such uncertainties would be created if interpretation of boilerplate provisions were submitted to juries sitting in every judicial district in the nation.

Sharon Steel Corp., 691 F.2d at 1048; accord Broad v. Rockwell Int'l Corp., 5th Cir., 642 F.2d 929, 943 (1981). While future adjudications in the Court of Chancery do not pose the same risk of inconsistent interpretations, individual factual determinations about who drafted what would introduce a similar degree of inconsistency between identically worded documents.

We are left then with a hopelessly ambiguous contract and a reluctance to rely upon extrinsic evidence.

Burden of the Ambiguity

It is a well-accepted principle that ambiguities in a contract should be construed against the drafter. . . . Courts have disagreed, however, whether the principle should apply in the case of detailed indentures or similar documents.[79] This reflects, in part, contrasting views regarding the respective roles played by underwriters and issuers. *See, e.g., Simons v. Cogan, Del.Ch., 542 A.2d 785, 791 (1987), aff'd, Del.Supr., 549 A.2d 300 (1988)* (*"*Underwriters of convertible securities do have an interest in negotiating protection on points regarded as material by ultimate purchasers of those securities.*"*); *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., S.D.N.Y., 716 F. Supp. 1504, 1509 (1989)* (*"*Since the underwriters must then sell or place the bonds, they necessarily negotiate in part with the interests of the buyers in mind.*"*).

In *B.S.F. Co. v. Philadelphia Nat'l Bank, Del.Supr., 204 A.2d 746 (1964)*, the Court reversed a decision of the Court of Chancery which construed against the issuer what the Court of Chancery considered an ambiguous indenture provision. This Court, applying Pennsylvania law, did not consider the applicability of the principle to indentures because it found that the language was not ambiguous. *Id. at 751* (*"*The difficulty we think with this holding is that there is no ambiguity in the Indenture.*"*). Unlike the indenture at issue in *B.S.F.*, however, the ambiguity here is manifest and insoluble.

We agree that *"*[w]hile debtor corporations are not the actual drafters of bond contracts, they are in a much better position to clarify the meaning of . . . contract terms in advance of disputes than are investors generally.*"* Tauke, *1989 Colum.Bus.L.Rev. at 87*. The issuer is *"*better able to clarify unclear bond contract terms in advance so as to avoid future disputes and therefore should bear the drafting burden that the *contra proferentem* principle would impose upon it.*"* *Id. at 89*; *see also Simons, 542 A.2d at 786* (*"*the purchaser . . . is offered, and voluntarily accepts, a security whose myriad terms are highly specified*"*). Moreover, when faced with an ambiguous provision in a document such as the Certificate, the Court must construe the document to adhere to the reasonable expectations of the investors who purchased the security and thereby subjected themselves to the terms of the contract. *Rhone-Poulenc, 616 A.2d at 1196*.

We caution against this principle becoming *"*a short-cut for avoiding the sometimes difficult tasks of determining expectations. . . .*"* Tauke, *1989 Colum.Bus.L.Rev. at 88*. Certificates of Designation and indentures are necessarily complex documents prepared by sophisticated drafters. They require some effort and careful thought to understand. In the normal course of events, the four corners of the document will yield a result which is consistent with reasonable expectations. *See* William W. Bratton, Jr., *The Interpretation of Contracts Concerning Corporate Debt Relationships*, 5 Cardozo L. Rev. 371, 379 (1984). We apply the *contra proferentem* principle here only as a last resort because the language of the Certificate

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[79] *Compare Prescott, Ball & Turben v. LTV Corp., S.D.N.Y., 531 F.Supp. 213, 217 (1981), with Morgan Stanley & Co., Inc. v. Archer Daniels Midland Co., S.D.N.Y., 570 F.Supp. 1529, 1541 (1983).*

presents a hopeless ambiguity, particularly when alternative formulations indicate that these provisions could easily have been made clear.[80]

Conclusion

The Vice Chancellor's approach in this case was correct and well done, particularly considering the fact that his decision making in this complex and unusual matter was accomplished in the very short time frame appropriate for injunction proceedings. We share the Vice Chancellor's concern that it is difficult to find that drafters of sophisticated corporate documents left such an ambiguity as this one and were relegated to rely on the uppercase-lowercase rationale. The Vice Chancellor correctly concluded that this rationale could not save the corporate document from foundering on the reef of its own ambiguity.

Since we hold that the Certificate does not permit Kaiser unilaterally to change the conversion rights of the PRIDES, as contemplated in the proposed amendment to its Certificate of Incorporation, we need not reach the other contentions raised by the parties. Our disposition here is limited to the question of whether the preliminary injunction ordered by the Court of Chancery was properly granted. We do not speculate on future steps the parties may undertake in light of this Opinion. In order to secure more permanent relief, Plaintiffs must still press their claims at the trial level. Accordingly, the interlocutory order of the Court of Chancery granting the preliminary injunction is **AFFIRMED** and the matter is **REMANDED** to the Court of Chancery for further proceedings consistent with this Opinion. Jurisdiction is not retained.

§ 5.12 POISON PILL PROVISIONS

Page 609 add the following after the first sentence of the first paragraph

The necessity for the pill arises from what Delaware Chancellor William Allen referred to as an anomaly:

> "[p]ublic tender offers are, or rather can be, change in control transactions that are functionally similar to merger transactions with respect to the critical question of control over the corporate enterprise. Yet, under the corporation law, a board of directors which is given the critical role of initiating and recommending a merger to the shareholders (*see* [Section 251 of the Delaware General Corporation Law § 1.08 *supra*]) traditionally has been accorded no statutory role whatsoever with respect to a public tender offer for even a controlling number of shares. This distinctive treatment of board power with respect to mergers and tender offers is not satisfactorily explained by the observation that the corporation law statutes were basically designed in a period when large scale public tender offers were rarities; our statutes are too constantly and carefully massaged for such an explanation to account for much of the story. More likely, one would suppose, is the conceptual notion that tender offers essentially represent the sale of shareholders' separate property and such sales-even when aggregated into a single change in control transaction-require no "corporate" action and do not involve distinctively "corporate" interests.

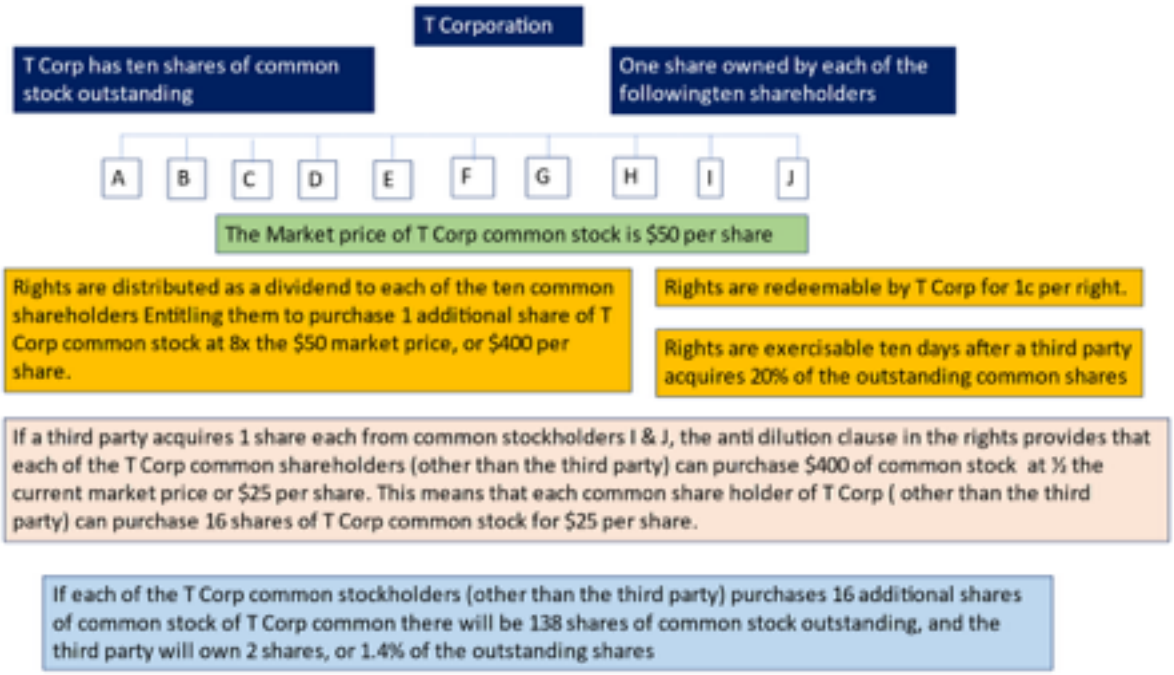
[80] *Contra Prescott, Ball & Turben v. LTV Corp., S.D.N.Y., 531 F.Supp. 213, 217 (1981).*

> This justification, however, would have no doubt been felt as ethereal, not to say illusory, by those responsible for the management of corporations as the public tender offer, particularly uninvited or hostile tender offers, became an increasingly common form of transaction in the 1970s. The so-called *"poison pill"* can, of course, be seen as an attempt to address the flaw (as some would see it) in the corporation law that gives a board of directors a critical role in mergers (and other extraordinary transactions) but gives it no role with respect to public tender offers-a form of extraordinary transaction that threatens equivalent impacts upon the corporation and all of its constituencies including existing shareholders. Thus, with the development of that innovation, boards of directors began taking upon themselves, unilaterally in practically all instances, the power to reject a public tender offer (or more correctly, to preclude its completion as a practical matter) by adopting the poison pill stock rights plan."[81]

Also Page 609: In the next paragraph change "originally" to "initially."

Page 610: Add the following immediately above Moran v. Household International, Inc.

Hypothetical Example of Flip In Poison Pill



Page 629: Add the following to Note (1).

Section 912(a) of the BCL defines an Interested shareholder as the owner of twenty percent of more of the outstanding voting stock of a New York corporation. Accordingly, a New York corporation cannot have a NOL poison pill applicable to five percent holders such as that in *Versita Enterprises, Inc. v. Selectica, Inc., 5 A.3d 586 (2010)*. In *Amalgamated Sugar Co. v. NL*

[81] *TW Servs., Inc. v. SWT Acquisition Corp*., 1989 WL 20290 at *9 (Del. Ch. Mar. 2, 1989).

industries, Inc., *644 F. Supp. 1229, 1234 (S. D. N. Y. 1986)*, which was analyzed with approval in *Bank of New York,* the District Court held that what the Court considered a similar statutory scheme in the New Jersey Business Corporation Law (Sections 14A 7-1 and 7-2) rendered a New Jersey corporation's flip in poison pill *ultra virus,* and stated that "[t]he flip-in effects a discrimination among shareholders of the same class or series." Unlike the former New York Section 501(c) however, the New Jersey statutes (which remain unchanged) did not unequivocally state that "each share shall be equal." Such discrimination by a Delaware corporation is permissible by reason of the holding in *Unocal.* (*See* Chapter 6, Section 6.03, *infra*.)

Page 629 Eliminate the present text in Note (2) and substitute the following:

In *Air Prods. & Chems., Inc v. AirGas, Inc.,*[82] after a year long takeover battle which had reached a "crossroads", Chancellor Chandler declined to order the target's board to redeem a poison pill. At the conclusion of his 129 page opinion, he stated:

> "There is no question that poison pills act as potent anti-takeover drugs with the potential to be abused. Counsel for plaintiffs (both Air Products and Shareholder Plaintiffs) make compelling policy arguments in favor of redeeming the pill in this case—to do otherwise, they say, would essentially make all companies with staggered boards and poison pills "takeover proof." The argument is an excellent sound bite, but it is ultimately not the holding of this fact-specific case, although it does bring us one step closer to that result.

As this case demonstrates, in order to have any effectiveness, pills do not—and cannot—have a set expiration date. To be clear, though, this case does not endorse "just say never." What it does endorse is Delaware's long-understood respect for reasonably exercised managerial discretion, so long as boards are found to be acting in good faith and in accordance with their fiduciary duties (after rigorous judicial fact-finding and enhanced scrutiny of their defensive actions). The Airgas board serves as a quintessential example.

Directors of a corporation still owe fiduciary duties to *all stockholders*—this undoubtedly includes short-term as well as long-term holders. At the same time, a board cannot be forced into *Revlon* mode any time a hostile bidder makes a tender offer that is at a premium to market value. The mechanisms in place to get around the poison pill—even a poison pill in combination with a staggered board, which no doubt makes the process prohibitively more difficult—have been in place since 1985, when the Delaware Supreme Court first decided to uphold the pill as a legal defense to an unwanted bid. That is the current state of Delaware law until the Supreme Court changes it.

For the foregoing reasons, Air Products' and the Shareholder Plaintiffs' requests for relief are denied, and all claims asserted against defendants are dismissed with prejudice."[83]

On the other hand, in the absence of a specific activist threat, the Delaware Chancery Court held that a Board's adoption of a rights plan with a five percent ownership trigger and an

[82] 16 A.3d 48 (Del. Ch.2011).

[83] 16 A.3d at 129.

expansive definition of acting in concert was determined to be a breach of the Directors' duties under *Unocal* and thus unenforceable.[84]

[84] *The Williams Companies Stockholder Litigation*, *2021 WL 754593 Del. Ch. February 26, 2021*.

Chapter 6

DISTRIBUTIONS IN RESPECT OF EQUITY SECURITIES

§ 6.01 LEGAL AND BUSINESS ASPECTS OF DIVIDENDS

Page 690: Add the following after AFFFIRMED

NOTE

Section 544(b) of the Bankruptcy Code permits a Chapter 11 Trustee to set aside any transfer of property of the debtor that is voidable under applicable state law. Section 546(e), however, provides that a trustee may not set aside a "settlement payment" as defined in the Code and judicially interpreted to include "any payment 'made in the securities trade to consummate securities transactions."[85] In a 1996 companion case to the above *Mumford* decision, the Eleventh Circuit[86] held that the 546(e) exception does not apply to LBO payments to stockholders, a position that does not appear to be the majority view. For example, in *In re Tribune Company Fraudulent Conveyance Litigation,*[87] the Court stated "concern has been expressed that LBOs are different from other transactions in ways pertinent to the Bankruptcy Code . . . . However, the language of Section 546(b) does not exempt from its protection payments by firms to intermediaries to fund ensuing payments to shareholders for stock."

Page 701: insert the following after Note (2).

IN RE ABBVIE INC. STOCKHOLDER DERIVATIVE LITIGATION
Delaware Chancery Court
2015 WL 4464505 (2115)

GLASSCOCK , VICE CHANCELLOR

Where a corporation creates and then spins off a subsidiary, there is obvious business value in a clean break between the new entity and the old, including through mutual general releases of liability between the entities, and their employees and directors, as part of the transaction. Of course, where the directors approve such a release, which includes release of their *own* liability for theoretical claims that formerly the company, and now the sub, may have against them, they convey some benefit to themselves as well. Whether such an approval, useful to the company on its face, invokes an equitable remedy nonetheless, on account of the directors' self-dealing, depends on the extent to which tangible, valuable choses in action against the directors are released, and on the directors' knowledge of such potential liability at the time they approved the transaction.

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[85] George V. Utlik & Schulyer G. Carroll, The Safe Harbor Provided for "Settlement Payments by Section 546(e), 19 *Norton Journal Of Bankruptcy Law And Practice*, 321, 323 (2010) quoting from *In re Enron Creditors Recovery Corp.*, 422 B.R. 423 (2009).

[86] *Matter of Mumford, Inc.*, 98 F.3d 604 (11th Cir. 1996).

[87] 818 F.3d 98, 122 (2nd Cir. 2016).

The matter before me involves the creation of a subsidiary, AbbVie Inc. (*"*AbbVie*"*), by Abbott Laboratories (*"*Abbott*"*), the transfer of assets and liabilities to AbbVie (including those relating to the drug TriCor, a former Abbott property), and, as part of that transfer, mutual releases that are problematic for the reasons described above. Subsequently, Abbott distributed all of its 100% interest in AbbVie as a dividend to its stockholders, who thereby became AbbVie stockholders as well. The Plaintiffs, AbbVie stockholders, seek to sue derivatively on behalf of AbbVie, alleging that at the time AbbVie was created, a former Abbott employee was pursuing damages in a *qui tam*[88] action against Abbott for purported violations of the False Claims Act in connection with Abbott*'*s marketing of TriCor (the *"*Qui Tam Action*"*); that the Qui Tam Action persists, resulting in defense costs payable by AbbVie, and *might* result in damages against AbbVie, which has assumed the TriCor liability; and that the facts of the Qui Tam Action *might* disclose that a chose in action existed at the time AbbVie was created, in favor of Abbott against its directors, under a theory of failure of oversight under the *Caremark* rationale or under a theory of bad faith. The Plaintiffs further assert that, should damages result from the Qui Tam Action, Abbott *would not* have an incentive to pursue a claim against its directors, because it had transferred TriCor-related liability to AbbVie and thus would suffer no damages, and AbbVie *could not* pursue the claim due to the mutual releases. In other words, the Plaintiffs point to that equitable anathema, a wrong without a remedy. They purport to sue the defendant directors derivatively on behalf of AbbVie, alleging that the releases represent a conflicted transaction, or constitute waste. The Plaintiffs seek to set aside the releases, freeing AbbVie—and the Plaintiffs derivatively —to pursue a *Caremark* or bad faith claim against Abbott*'*s directors, should the Qui Tam Action prove fruitful and should the facts warrant.

*2 The Plaintiffs lack statutory standing to derivatively sue the defendant directors for breach of duty in connection with the releases on behalf of AbbVie because they were not AbbVie stockholders at the time of the alleged wrong. They contend correctly, however, that this Court in *Shaev v. Wyly*[89] has allowed such an action in similar procedural circumstances, despite the statute, in light of otherwise-irremediable self-dealing by directors of a parent. The remedy problem the Plaintiffs point to is real, and analogous to *Shaev*, but unlike that case, the equitable considerations here are too tenuous to support the equitable exception to the statute that Plaintiffs invoke.

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[88] "*Qui tam*" is from the Latin phrase "*qui tam pro domino rege quam pro se ipso in hac parte sequitur*," which translates to: "who as well for the king as for himself sues in this matter." Black's Law Dictionary (10th ed. 2014). It is "[a]n action brought under a statute that allows a private person to sue for a penalty, part of which the government or some specified public institution will receive." *Id.*

[89] *1998 WL 13858 (Del. Ch. Jan. 6, 1998) aff'd*, *719 A.2d 490 (Del. 1998)*.

I. BACKGROUND FACTS[90]

A. The Spin-Off and Separation Agreement

In April 2012, Abbott incorporated AbbVie as its wholly owned subsidiary to hold Abbott's research-based pharmaceutical business. On November 28, 2012, Abbott's board of directors approved the separation of Abbott and AbbVie. The two entities entered into the Separation and Distribution Agreement By and Between Abbott Laboratories and AbbVie Inc. (the "Separation Agreement"), and Abbott declared a special dividend distribution of all outstanding shares of AbbVie common stock. On January 1, 2013, Abbott made the pro rata distribution of 100% of AbbVie's outstanding common stock to the Abbott stockholders of record as of December 12, 2012. AbbVie then became a publicly traded company on the New York Stock Exchange.

The Separation Agreement set forth the transfer of assets and liabilities from Abbott to AbbVie. It also contained "mutual releases," pursuant to which Abbott and AbbVie each released the other of all liability in connection with the assets transferred to AbbVie and the assets retained by Abbott, respectively.[91] Relevant here, AbbVie's release of Abbott provided that AbbVie "does hereby . . . remise, release and forever discharge: (1) Abbott, each Abbott Subsidiary, and their respective successors and assigns; [and] (2) all Persons who at any time are or have been shareholders, directors, officers, agents or employees of Abbott or an Abbott Subsidiary" from all liabilities transferred to AbbVie (the "Release").[92] The liabilities transferred to AbbVie included those associated with the drug TriCor, an asset that was transferred to AbbVie.

At the time of the Release, the Qui Tam Action was (and it remains) pending. The Qui Tam Action was brought by a former employee in 2009, alleging that, during the time of her employment (2000 to 2008), Abbott engaged in marketing TriCor for off-label uses, in violation of the False Claims Act. The United States declined to intervene, and the action is being prosecuted by the relator, the former employee, on behalf of the United States. In January 2014, over a year after the Release was executed, a federal district court granted in part and denied in part Abbott's motion to dismiss the claim.[93]

B. The Parties

The Plaintiffs were Abbott stockholders at the time of the Separation Agreement and received AbbVie stock in connection with Abbott's special dividend distribution on January 1, 2013. They have continuously held AbbVie stock since that time.

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[90] Unless otherwise indicated, all facts are taken from the Consolidated Amended Verified Shareholder Derivative Complaint for Breach of Fiduciary Duty for Self-Dealing, Waste of Corporate Assets, and Unjust Enrichment (the "Complaint").

[91] *See* Compl. ¶¶ 30-31; Opening Br. in Supp. of Mots. To Dismiss the Consolidated Am. Verified S'holder Deriv. Compl. Ex. A § 4.01.

[92] *Id.* § 4.01(a).

[93] *See U.S. ex rel. Bergman v. Abbot Labs., 995 F.Supp.2d 357, 363 (E.D. Pa. 2014)*. The Defendants represent that the Qui Tam Action makes no allegations about Abbott's directors.

*3 The nominal defendant AbbVie is a Delaware corporation with its principal place of business in Chicago, Illinois.

Defendant Richard A. Gonzalez, AbbVie's Chairman and CEO, signed the Separation Agreement on behalf of AbbVie.

The individual defendants include certain directors who sit on both the Abbott and AbbVie boards, who approved the Separation Agreement in their capacity as Abbott directors at the time: Robert J. Alpern, Roxanne S. Austin, Edward M. Liddy, and Glenn F. Tilton.

The remaining members of Abbott's board who approved the Separation Agreement on behalf of Abbott are also individual defendants: Sally E. Blount, W. James Farrell, Nancy McKinstry, Phebe N. Novakovic, William A. Osborn, Samuel C. Scott III, and Miles D. White, who is also Abbott's CEO. Gonzalez, Alpern Austin, Liddy, Tilton, Blount, Farrell, McKinstry, Novakovic, Osborn, Scott, and White are together referred to as the "Individual Defendants."

C. Procedural History

*****Plaintiff Donald Dempster filed a complaint on July 31,2014. A second complaint, by plaintiff Richard W. Berstein Irrevocable Family Trust-2006, was filed on August 12, 2014. I consolidated these actions on September 17, 2014. The Defendants filed motions to dismiss on October 17, 2014 and briefs in support of those motions on December 1, 2014. In response, the Plaintiffs filed the Amended Complaint on January 16, 2015. The Defendants again moved to dismiss and the parties submitted briefing on those motions that concluded in June. I heard oral argument on July 13, 2015.

II. STANDARD OF REVIEW

Under Rule 23.1, which, among other things, procedurally implements *8 Del. C.* § 327,[94] a derivative plaintiff must allege that he owned stock at the time of the complained-of transaction or that his shares devolved upon him by operation of law.[95]

Standing is a legal question that is well suited to resolution on a motion to dismiss. Where, as here, the question of standing is "so closely related to the merits," and the question is not whether this Court has jurisdiction to grant requested relief to *any* plaintiff, but rather, is whether the Court can grant the requested relief to *these* plaintiffs, the appropriate framework is under Rule 12(b)(6).[96]

On a motion to dismiss under Rule 12(b)(6), this Court accepts as true all well pleaded factual allegations, including even vague allegations if they give the opposing party notice of the

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[94] *See Quadrant Structured Products Co. v. Vertin, 102 A.3d 155, 178 (Del. Ch. 2014).*

[95] Ct. Ch. R. 23.1. Rule 23.1 also requires a plaintiff to allege with particularity that demand has been made and wrongfully refused or that it would be futile and should be excused. Because I am deciding the pending Motions to Dismiss solely on the standing requirement set forth in *8 Del. C. § 327* and implemented by Rule 23.1, as discussed below, I need not reach the demand futility argument and the heightened pleading standard that it entails.

[96] *Appriva S'holder Litig. Co., LLC v. EV3, Inc., 937 A.2d 1275, 1285 (Del. 2007).*

claim, and draws all reasonable inferences in favor of the non-moving party.[97] The Court will deny a motion to dismiss unless, with the foregoing principles in mind, there is no reasonably conceivable set of circumstances under which the plaintiff could recover.[98]

III. ANALYSIS

*4 The Plaintiffs, in their capacity as AbbVie stockholders, are seeking to pursue derivatively a claim against certain of both Abbott's and AbbVie's directors for breaches of fiduciary duties in connection with their approval of the Release. The Plaintiffs allege:

> [B]ecause the wrongful conduct . . . occurred when AbbVie was a wholly owned subsidiary of Abbott and in connection with the Separation Agreement, in the context of this derivative action, the Individual Defendants owed fiduciary duties to Abbott shareholders prior to and in connection with the Separation, to Abbott, AbbVie's sole shareholder before the spin-off, and to AbbVie shareholders at and after the time of the Separation Agreement.[99]

The Plaintiffs, however, purport to sue only on behalf of AbbVie.

The alleged harm in approving the Release, which approval the Plaintiffs contend was a self-dealing transaction, is that AbbVie has incurred litigation expenses relating to, and faces potential liability from, the Qui Tam Action, but is left without a chose in action against Abbott's directors for purported breaches of their fiduciary duties of loyalty in connection with the TriCor marketing. The ultimate relief sought is that the Release be rescinded, so that AbbVie may sue the Abbott directors for bad faith or lack of oversight in connection with the marketing of TriCor, and thus recoup any loss to AbbVie that might, hypothetically, result from the Qui Tam Action.

A stockholder wishing to pursue a derivative claim on behalf of a corporation must meet the standing requirements set forth in *8 Del. C.* § 327:

> In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law.[100]

The Plaintiffs cannot meet this requirement since AbbVie was a wholly owned subsidiary at the time of the complained-of transaction, *i.e.*, the Release, in November of 2012, and because the Plaintiffs received their stock by an Abbott dividend, rather than by operation of

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[97] *Central Mortg. Co. v. Morgan Stanley Mortg. Capital Holdings LLC*, 27 A.3d 531, 535 (Del. 2011).

[98] *Id.*

[99] Compl. ¶ 24.

[100] As noted above, this statutory requirement is implemented by *Court of Chancery Rule 23.1*. *See Quadrant Structured Products Co. v. Vertin, 102 A.3d 155, 178 (Del. Ch.2014)*.

law.[101] The Plaintiffs, however, argue that they should be accorded equitable standing in order to redress a wrong to AbbVie that would otherwise go unremedied, consistent with this Court's holding in *Shaev* v. Wyly.[102]

In *Shaev*, a stockholder of a subsidiary sought to bring derivatively a claim on behalf of that subsidiary. The plaintiff had long been a stockholder of the parent entity and received shares in the subsidiary as a result of a spin-off of the parent's wholly owned subsidiary and a subsequent dividend. Prior to the spin-off, the subsidiary's directors granted themselves options on nine million shares of the subsidiary's stock, conveying to themselves corporate property with a net value of up to $245 million, which the plaintiff alleged to be excessive compensation. In finding that the plaintiff had standing to pursue the claim on behalf of the subsidiary, the Court noted that the plaintiff at one time had standing to maintain a double-derivative action as a stockholder of the parent entity, but had lost that right once the spin-off was complete. The Court noted that "to deny standing on these facts would insulate defendants from potential liability for their alleged misdeeds."[103] It also noted that the purpose of Section 327 is to prevent the purchase of stock after a transaction solely for the purpose of pursuing a derivative claim based on that transaction, an evil absent in *Shaev* (and here as well).[104]

*5 On a motion for reargument, the Court reiterated that its decision was a matter of equity:

> Here, plaintiff lost his chance to file a double derivative action because, after the spin-off, [the parent] and [the subsidiary] were no longer in a parent/subsidiary relationship. Were this Court to apply section 327 strictly, plaintiff would also be barred from filing a derivative action. Under those circumstances, I refuse, as I believe one charged with the duty to apply equitable principles must, to adhere blindly to a technical legal rule and to allow thereby an alleged corporate wrongdoer to thumb his nose at the possibility of redress. Thus, I found that plaintiff has *equitable* standing to bring a derivative action on [the subsidiary's] behalf, notwithstanding the fact that the challenged actions occurred before he owned any [of the subsidiary's] stock.[105]

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[101] The Complaint avers that the Plaintiffs received their shares by operation of law, but the Plaintiffs' briefing and oral argument more appropriately, in light of the receipt of shares by contract, relied on the theory of equitable standing under *Shaev*.

[102] *1998 WL 13858 (Del. Ch. Jan. 6, 1998) aff'd, 719 A.2d 490 (Del. 1998)*.

[103] *Id.* at *4.

[104] *Id.* at *4, n.19.

[105] *Shaev v. Wyly*, *1998 WL 118200, at *2 (Del. Ch. Mar. 6, 1998), aff'd, 719 A.2d 490 (Del. 1998)* (emphasis in original).

The Plaintiffs contend that *Shaev* is on point with the present case: Like the Plaintiffs here, the plaintiff in *Shaev* challenged a transaction that allegedly harmed a wholly owned subsidiary, of which the plaintiff became a stockholder by way of dividend following a spin-off.

I do not read *Shaev* to say that the ownership requirement of Section 327 only applies where the Court determines that the plaintiff's motive is champertous, and otherwise is waived; such a policy determination would be for the legislature. Instead, I read *Shaev* to hold that this Court will not countenance a wrong to stockholders by fiduciaries that is both egregious and irremediable; instead, this Court will employ a special equitable standing on behalf of a stockholder, where the complaint discloses a wrong abhorrent to equity. While this case and *Shaev* are procedurally similar, I find the equitable considerations at play in *Shaev* to be lacking here because the Plaintiffs have not pled facts from which I can reasonably infer that *AbbVie* was harmed.

The Plaintiffs allege that the Individual Defendants (other than Gonzalez, who was not an Abbott director at the time) "knowingly or recklessly acted contrary to the interests of Abbott and AbbVie when they approved the Separation Agreement because they failed to provide any material consideration to Abbott or AbbVie in exchange for the Release of liability."[106] The Plaintiffs allege that Gonzalez, AbbVie's CEO, was "acting contrary to the interests of Abbott when he signed the Separation Agreement [on behalf of AbbVie, then Abbott's wholly owned sub] because he failed to provide any material consideration to Abbott in exchange for the Release of liability."[107]

Even accepting as true all well pleaded factual allegations and drawing all reasonable inferences therefrom, I do not find it reasonably conceivable that AbbVie has been harmed such that the Plaintiffs here should be afforded equitable standing to proceed on behalf of AbbVie for alleged wrongdoing that occurred while AbbVie was a wholly owned subsidiary of Abbott.

*6 I note at the outset that there is not a reasonably conceivable waste claim against the Individual Defendants for their approval of the Release. Waste involves claims that a board "'irrationally squander[ed]' corporate assets —for example, where the challenged transaction served no corporate purpose or where the corporation received no consideration at all."[108] I do not find it reasonably conceivable that the Release lacked any business purpose. This Court has long recognized that derivative litigation is burdensome to companies, by way of the direct costs of the litigation, including advancement and indemnification obligations, as well as indirect costs, such as distraction to management and the board, and possible detriment to employee morale.[109] The Release here, moreover, is *not* simply a release of the defendant directors; it is a

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[106] Compl. ¶ 96.

[107] *Id.* ¶ 95.

[108] *White v. Panic, 783 A.2d 543, 554 (Del. 2001)*.

[109] *See, e.g.*, *In re INFOUSA, Inc. S'holders Litig., 953 A.2d 963, 986 (Del. Ch. 2007)* ("A board may in good faith refuse a shareholder demand to begin litigation even if there is substantial basis to conclude that the lawsuit would eventually be successful on the merits. It is within the bounds of business judgment to conclude that a lawsuit, even if legitimate, would be excessively costly to the corporation or harm its long-term strategic interests.").

broad general release via which the two entities ensured their full legal separation, free of entanglement. To say that the Release is entirely devoid of value is conclusory and will not withstand judicial scrutiny, even on the lenient motion-to-dismiss standard, in the absence of any facts from which I could reasonably infer that these benefits were lacking. The Complaint makes no such pleading.

Further to the point, the inchoate *benefit* to Abbott's directors at the time of the Release, and the corresponding "loss" to Abbott and its wholly owned subsidiary, AbbVie, is too attenuated to reasonably support an inference that the Release was a self-dealing transaction that harmed AbbVie and requires an equitable override of *Section 327*. At the time of the Release, the United States had already declined to intervene in the Qui Tam Action, in which it is the theoretical party-in-interest,[110] and Abbott had filed a motion to dismiss.[111] Even if the Action results in some kind of payout for which AbbVie is responsible because of the transfer of that liability from Abbott, there would remain a daunting leap between AbbVie's monetary liability for Abbott's off-label marketing of TriCor and Abbott's directors being personally liable for bad faith or failure of oversight in connection with that marketing. The pleadings are devoid of allegations that would support such a claim against Abbott's directors for the company's improper marketing of TriCor.[112]

Because I do not find it reasonably conceivable that harm to AbbVie[113] sufficient to compel equity to act arose from the Release, there are no grounds to depart from the general rule set forth in *8 Del. C.* § 327 and grant equitable standing to the Plaintiffs here. Because I find the Plaintiffs lack standing to pursue this claim on behalf of AbbVie, I need not reach the other grounds for the Defendants' Motions to Dismiss. Defendants' Motions to Dismiss are, accordingly, granted.

*7 To the extent the foregoing requires an order to take effect, IT IS SO ORDERED.

Sincerely,

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[110] *See supra* note 1.

[111] *See U.S. ex rel Bergman v. Abbot Labs., 995 F.Supp. 2d 357, 363 (E.D. Pa. 2014)*.

[112] The Complaint alleges that Abbott has faced scrutiny in the past for off-label marketing and that its peers have as well. It alleges that off-label marketing is endemic in the pharmaceutical industry. In particular, the Complaint alleges, in May 2012, Abbott paid a $1.5 billion settlement to resolve criminal and civil investigations regarding off-label marketing of *Depakote*. *See, e.g.*, Compl. ¶¶ 79-80. It does not, however, plead the Individual Defendants' culpability with respect to illegality in marketing TriCor, except in conclusory fashion.

[113] In *Shaev*, the defendant directors conferred upon themselves options in the subsidiary's stock which would allow them to "extract from [the sub] between $139 million and $245 million." *Shaev v. Wyly 1998 WL 1358, at *1 (Del. Ch. Jan. 6, 1998), aff'd, 719 A.2d 490 (Del. 1998)*. Here, by contrast, incidental to a general mutual release, the defendant directors allegedly insulated themselves from liability for a theoretical fiduciary duty action that remains a gleam in the Plaintiff's eyes. Because I find that the release, unlike the self-dealing transfer of assets in *Shaev*, does not offend equity so as to require equitable standing, this case must be dismissed. Having reached this result, I need not decide whether any action for breach of duty in regard to the release properly belongs to AbbVie—as the Plaintiffs assert—or to Abbot, or Abbot's stockholders who received the AbbVie shares directly. Nor need I decide whether liability of the directors arising from any illegal marketing of TriCor—which allegedly occurred by 2008—could withstand the application of the doctrine of laches.

/s/ Sam Glasscock III

Sam Glasscock III

All Citations

Not Reported in Atl. Rptr., 2015 WL 4464505

§ 6.02 STOCK DIVIDENDS AND STOCK SPLITS

Page 723: Add the following above § 6.03

CLARK v. PATTERN ANALYSIS AND RECOGNITION CORP.
New York Supreme Court, Oneida County
87 Misc.2d 385, 384 N.Y.S.2d 660 (1976)

PARKER J. STONE, J.

Plaintiffs commenced an action against the defendant, Pattern Analysis and Recognition Corporation (PAR) to enjoin the carrying out of a plan of recapitalization by which the plaintiffs would be forced to sell their shares of stock in PAR at a stated price. Plaintiffs have simultaneously made a motion for a preliminary injunction pending the determination of the main action. PAR opposes the motion.

* * * *

There is no question that the proposed recapitalization of the corporation would cause irreparable damage to plaintiffs as they would lose their status as shareholders. Whether plaintiffs have a strong probability of ultimate success depends upon a review of the pleadings and affidavits and a determination of the substantive merits of the action. The uncontested facts are briefly as follows:

The plaintiffs are former employees of PAR and during the course of their employment, they purchased shares of stock in PAR. After the plaintiffs left the employ of PAR, the board of directors and shareholders of PAR, by a majority vote, amended the certificate of incorporation and adopted a plan of recapitalization by which the outstanding shares of stock of PAR would be reduced on a ratio of 4,000 shares for every new share of the recapitalized issue. The effect of this plan was to reduce the authorized shares from 1,000,000 shares to 250 shares.

The plaintiffs each own less than 4,000 shares. Consequently, under the proposed plan, the plaintiffs would each own less than one share. As part of the same resolution, the issuance of fractional shares was disallowed and the corporation was authorized to purchase fractional shares on the basis of $1.50 per share, if the shareholders did not dissent, or $1.25 per share, if the shareholders did dissent.

The combined effect of the reclassification of shares and the refusal to issue fractional shares results in the plaintiffs being forced to sell their shares of stock.

Reclassification of stock by the vote of a majority of shareholders is unquestionably authorized by section 801 (subds [a], [b], par [11]) and *subdivision (a) of section 803 of the Business Corporation Law*. Additionally, *sections 509 and 513 of the Business Corporation Law* give to a corporation the option to issue fractional shares of stock or pay in cash the fair value of these fractional shares. The issue then which must be decided is whether the combined use of these two procedures under the specific facts of this case states a cause of action in favor of plaintiffs against PAR. Neither counsel nor the court is aware of a decision on this specific issue by a court of this State.

* * * *

[A] minority stockholder will be protected against the threatened acts of a board of directors or managing stockholders if those acts violate their fiduciary obligations and cause the minority shareholder to sustain damage. This is so notwithstanding the fact that the corporation follows statutory mandates to the letter.

* * * *

PAR has submitted in support of its position, a case decided by the Supreme Court of Illinois, *Teschner v. Chicago Tit. & Trust Co. (59 Ill 2d 452)*. The plaintiff in the *Teschner* case was the owner of 63 shares out of 2,233,321 common shares issued by the defendant, Chicago Title and Trust Company. She refused to participate in either an exchange offer or the sale of her stock to another corporation (also a named defendant) which had acquired all but 1,890 shares held by 45 shareholders, including plaintiff. Chicago Title and Trust Company thereafter adopted a resolution to amend its articles of incorporation to reclassify the outstanding common shares into 3,722 shares, each new share having a par value of $4,000. The amendment would also provide that no stock certificates representing fractional shares would be issued, but in lieu thereof, the defendant would exercise its statutory option to acquire such fractional shares from its stockholders for cash. The amendment was approved and plaintiff became the only dissenting stockholder.

Plaintiff petitioned the court to restore her status as a shareholder and to declare the action of the corporation illegal and invalid as a breach of fiduciary duty and as depriving her of property without due process of law, violating her right to equal protection of the law and impairing her contract rights.

The Illinois Supreme Court upheld the corporate action and in doing so, noted that generally (p 456) *"*unless there is fraud which would entitle dissenting shareholders to other relief, interests of minority shareholders can be terminated.*"* In this particular case, however, the court found no allegation of wrongdoing in the complaint, nor could it discover evidence of improper purpose. *"*The plaintiff's complaint made no claim of fraud or deceptive conduct by the defendants. It did not charge that the exchange offer was unfair or that the price later offered for the shares was inadequate. The defendants stated in the circuit court that the corporate action of reclassifying stock and eliminating fractional shares was basically to reduce corporate expenses and simplify and facilitate procedures. The plaintiff did not allege or show any improper purpose on the part of the defendants. Considering the circumstances the judgment in favor of the defendants was proper.*"* *(Teschner, supra*, *pp 458-459*.)

* * * *

[A] minority shareholder under the law of this State should not be relegated to an appraisal right solely by reason of the fact that an appraisal right exists. Where there is an allegation of fraud, illegality or bad faith, coupled with a tenuous showing of legitimate corporate business purpose, fairness requires that a minority shareholder be afforded an opportunity to fully contest the actions of the majority before he is deprived of his property.

Where a strong and compelling corporate business purpose is shown, however, the courts should not interfere at the mere whim of a dissident shareholder.

Plaintiffs allege in their supporting affidavit "That such action of the corporation was taken without a substantial business purpose therefor and for the sole reason to eliminate all of the above named shareholders by payment to them of alleged book value of the shares. That said action is unlawful and fraudulent and taken for the sole purpose of depriving all of the above said persons of their shares in the corporation." PAR's affidavit in opposition indicates that the sole reason for the reclassification of shares and the elimination of fractional shares was to remove the plaintiffs as shareholders. This is clear from the affidavit of the president of PAR. This action by PAR is supposedly justified on the basis that all remaining shareholders would be employees of PAR having a substantial interest both with respect to stock ownership and management responsibility. Further, PAR contends that in this manner, the confidentiality of PAR's financial statements could be maintained. It is acknowledged by PAR, however, that there are other shareholders who are not employees of PAR but who are close relatives of shareholders and who, it is presumed, would remain as shareholders under the proposed recapitalization. Plaintiffs point out that PAR has never issued a financial statement to date; that the restrictions on the transfer of shares have never been imposed by the board of directors, nor has the board of directors authorized a right of redemption which would be exercised in the event a shareholder employee left his employment.

Upon all the proof submitted, the court finds that there is absent a strong and compelling legitimate business purpose supportive of the action taken by the defendant. Plaintiffs have demonstrated a strong probability of ultimate success to justify the granting of a temporary injunction pending the final determination of the issues.

Plaintiffs' motion is granted.

NOTE

See generally, Michael R. Rickman Reverse Stock Splits and Squeeze Outs: A Need for Heightened Scrutiny, 64 *Wash. U.L. Rev.* 1219 (1986).

Granewich v. Harding
Oregon Supreme Court
329 Or. 47, 985 P.2d 788 (1999)

GILLETTE, J.

This is a civil action for damages based on allegations that the controlling shareholders and directors of a closely held corporation breached their fiduciary duties to plaintiff, a minority shareholder and director, through a corporate "squeeze-out." Plaintiff named as defendants the majority shareholders and directors, the corporation itself, the corporation's lawyer, and that lawyer's firm. As the case comes to us, all claims against the corporation and the shareholders have been dismissed, and only the allegations concerning the lawyers' role in the alleged squeeze-out are at issue.

The amended complaint alleges, among other things, that the controlling shareholders and directors amended the corporate by-laws to exclude plaintiff from the corporation and issued new shares of stock to themselves to dilute plaintiff's ownership interest in the corporation. The complaint also alleges that the lawyers are liable directly to plaintiff for breach of their own fiduciary duties to him as a director by assisting in those actions and that they are jointly liable with the majority shareholders and directors for breach of their fiduciary duties to him as a minority shareholder and director.

* * * *

The amended complaint alleges the following facts: Founders Funding Group, Inc. (FFG) was incorporated in 1992. By early 1993, plaintiff and defendants Harding and Alexander-Hergert each owned one-third of the shares of FFG stock. Plaintiff, Harding, and Alexander-Hergert all were directors and officers of FFG as well as its employees. All three agreed initially that each would receive inadequate compensation for their respective services to the company but that each would receive the same amount of compensation from FFG, with the expectation and agreement that each ultimately would receive ample compensation for his or her efforts. They also agreed that each would be employed continually and perpetually by the corporation, with salaries and benefits commensurate with their services to it.

After a short time, FFG's business became substantially more successful and profitable. The complaint alleges that, at that point, Harding and Alexander-Hergert devised a plan to squeeze plaintiff out of the corporation. On May 5, 1993, they met with plaintiff and informed him that they had removed him as a director of FFG, relieved him of his executive position, and terminated him as an employee, all effective immediately. Plaintiff objected on the grounds that he had not received proper notice of any shareholders' or directors' meeting as required by FFG's by-laws, that his position as a director was protected by the cumulative voting requirements of the by-laws, that the actions of Harding and Alexander-Hergert represented a breach of the agreement between plaintiff and the others that each would be employed perpetually and continually by FFG, and that those actions represented a breach of the fiduciary duty that Harding and Alexander-Hergert owed to plaintiff by virtue of their ownership of two-thirds of the corporation's stock and their holding of two out of three positions on FFG's board of directors.

Soon thereafter, Harding and Alexander-Hergert, in their corporate capacities, met with and hired lawyer Farrell and his law firm, Martin, Bischoff, Templeton, Langslet & Hoffman (collectively, the lawyers), to provide legal services to the corporation. The complaint alleges that the lawyers then entered into an agreement with Harding and Alexander-Hergert to assist them in depriving plaintiff of his position as a director, of the value of his shares of stock, of his further employment with and compensation from FFG, and of the benefits of participating in the corporate affairs of FFG. The complaint alleges that, at all material times, the lawyers knew that the purpose of that agreement was to violate Harding's and Alexander-Hergert's fiduciary duties to plaintiff. Additionally, the complaint alleges that FFG itself "had no legitimate corporate interest in resolving the disputes between plaintiff * * * and defendants Harding and Alexander[-

Hergert] in a manner which favored defendants Harding and Alexander[-Hergert] over plaintiff * * *."

The lawyers are alleged to have assisted Harding and Alexander-Hergert by drafting and sending two letters to plaintiff, at Harding's and Alexander-Hergert's request, containing statements that the lawyers knew to be false concerning the effectiveness of Harding's and Alexander-Hergert's previous efforts to remove plaintiff from the corporation. It also is alleged that, in their further efforts toward the same end, the lawyers knowingly provided legal assistance to Harding and Alexander-Hergert that substantially assisted Harding and Alexander-Hergert in breaching the fiduciary duties that they allegedly owed to plaintiff. Specifically, the complaint alleges that the lawyers assisted Harding and Alexander-Hergert in exercising actual control of the management and policies of FFG in ways inconsistent with their claimed fiduciary duties by calling special meetings, amending corporate by-laws, removing plaintiff as a director, and taking other actions to dilute the value of plaintiff's FFG stock. Finally, the complaint alleges that the lawyers' actions were outside the scope of any legitimate employment by FFG and that plaintiff suffered damages as a consequence of those actions.

As a preliminary matter, defendant lawyers argue that the Court of Appeals erred in considering the "aid and assist" theory and urge this court not to address it, on the ground that plaintiff neither mentioned "aid and assist" as a separate theory of recovery in the complaint nor argued it below. Therefore, defendant lawyers argue, the matter is not preserved.

Defendant lawyers' argument is not well taken. For reasons explained more fully below, neither "conspiracy" nor "aid and assist" is a separate theory of recovery. *See Bonds v. Landers, 279 Or. 169, 175, 566 P.2d 513 (1977)* (so explaining with respect to "conspiracy.") Rather, conspiracy to commit or aiding and assisting in the commission of a tort are two of several ways in which a person may become jointly liable for another's tortious conduct.

Section 876 of the *Restatement (Second) of Torts* (1979) (*Restatement*) sets out three ways in which persons acting in concert may be held accountable for each other's tortious conduct:

> "For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he
>
> "(a) does a tortious act in concert with the other or pursuant to a common design with him, or
>
> "(b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
>
> "(c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person."

* * * *

We conclude that persons acting in concert may be liable jointly for one another's torts under any one of the three theories identified in *Restatement* section 876. * * * It follows that the Court of Appeals did not err in considering whether the lawyers jointly could be liable for the breach of fiduciary duty, either by doing a tortious act in concert with the others, as described in section 876(a) of the *Restatement,* or by knowingly providing substantial assistance to the others in their commission of that tort, as described in section 876(b). We turn to that issue.

There is no Oregon law directly addressing whether someone can be held liable for another's breach of fiduciary duty. Legal authorities, however, virtually are unanimous in expressing the proposition that one who knowingly aids another in the breach of a fiduciary duty is liable to the one harmed thereby. That principle readily extends to lawyers. None of those authorities even implies that liability for participants in the breach of fiduciary duty is confined to those who *themselves* owe such duty.

Nothing in this court's prior decisions compels a different conclusion in this case. Indeed, the theory behind joint liability is that persons acting in concert are liable for all the acts done in furtherance of the conspiracy. * * * Indeed, it especially would be odd for the law to afford beneficiaries of *fiduciary* relationships less protection from the malfeasance of third parties than would be available to the victims of other kinds of tortious conduct. We hold, therefore, that a defendant personally need not have committed a tortious act as a prerequisite to liability for acting in concert with another person who did commit that tortious act.

In reaching a contrary conclusion, the Court of Appeals found dispositive the absence of any duty flowing directly from the lawyers to plaintiff. That court stated that "because the tort of breach of fiduciary duty depends on a duty that the law implies from a fiduciary relationship between the parties, it necessarily follows that a fiduciary relationship must exist between the plaintiff and all joint tortfeasors.

* * * *

That analysis is faulty for two reasons. First, interpreting the term, "tortious act," in the way that the Court of Appeals' majority did requires, in the traditional tort law vernacular, that the actor owe a duty of care to the third person. Thus, that interpretation erroneously fuses together the elements of liability set out in subsection 876(a) with those in subsection 876(c), which outlines liability for persons who assist in the accomplishment of a tortious result in circumstances where their "own conduct, separately considered, constitutes a breach of duty to the third person." Such an approach would render subsection (c) surplusage.

Second, the Court of Appeals' analysis relies on the premise that, under subsection 876(a), each actor's conduct itself must constitute a tort before liability attaches. That reliance is misplaced. This court previously has suggested that a plaintiff need not establish that each person acting in concert himself committed a tort.

The Court of Appeals also declined to rule that lawyers can be held liable as co-conspirators merely for aiding and assisting in the commission of the tort of breach of fiduciary duty, on the ground that it unduly would interfere with lawyer-client relations if lawyers could be held liable for actions performed on behalf of their clients that only indirectly result in their

clients' breach of their fiduciary duties. In that regard, we note that the Court of Appeals interchangeably refers to Harding and Alexander-Hergert and to the corporation as the lawyers' clients. The complaint, however, alleges that the corporation hired the lawyers, that the corporation had no interest in the dispute between plaintiff and Harding and Alexander-Hergert, and that the work that the lawyers performed was outside the scope of any legitimate employment on behalf of the corporation. We must accept those allegations as true for purposes of our analysis. Under that circumstance, the lawyers stand in no different position in relation to plaintiff than anyone else, and their status as lawyers is irrelevant.

Viewed in light of the foregoing discussion, the amended complaint adequately alleges joint liability on the part of defendant lawyers as persons acting in concert with Harding's and Alexander-Hergert's alleged breach of their fiduciary duties to plaintiff.

* * * *

The amended complaint states a claim against the lawyers for joint liability, based on their alleged participation with other defendants in breaching fiduciary duties owed to plaintiff. The trial court erred in ruling to the contrary, and the Court of Appeals erred in affirming that ruling.

The decision of the Court of Appeals is reversed in part. The judgment of the circuit court is reversed in part. The case is remanded to the circuit court for further proceedings.

§ 6.03 PURCHASES BY A CORPORATION OF ITS OWN SHARES

[A] STATE STATUTORY PROVISIONS

Page 724: Add the following above Heckmann v. Ahmanson:

NEIMARK v. MEL KRAMER SALES, INC.
Court of Appeals of Wisconsin
102 Wis.2d 282, 306 N.W. 2d 278 (1981)

DECKER, CHIEF JUDGE.

This appeal questions whether the trial court erred in this shareholder's derivative action by ordering specific performance of a stock redemption agreement upon death of the principal shareholder of defendant corporation. We vacate the judgment and remand with directions.

Plaintiff seeks specific performance of an agreement for the redemption of stock owned by the late Mel Kramer (Kramer), founder and majority shareholder of Mel Kramer Sales, Inc. (MKS). MKS is a closely-held Wisconsin corporation engaged in the business of selling automotive parts and accessories. The interests of the shareholders are:

Shareholder	Number of Shares	Percentage
Mel Kramer/Estate of Mel Kramer	1,020	51

Delores Kramer	200	10
Jack Neimark	580	29
Jerome Sadowsky	200	10

Kramer died on December 5, 1976. On May 9, 1977, Delores Kramer, Kramer's widow, was appointed personal representative of his estate. Delores Kramer is president and a director of MKS. Jack Neimark is vice-president and a director. Directors David Gutkin and Sara Lee Begun are relatives of Delores Kramer.

On June 22, 1976, a stock redemption agreement was executed by MKS and its stockholders. The agreement requires MKS to purchase, and a deceased shareholder's estate to sell, all of the deceased shareholder's stock in MKS at $400 per share, less a specified credit.[114] The agreement also provided Delores Kramer with the option to sell her shares to MKS in the event of Kramer's death.

Under the agreement, Kramer's 1,020 shares were to be redeemed by MKS within thirty days after the appointment of his estate's personal representative, Delores Kramer, in the following manner. The redemption price of $408,000, less a specifically provided $50,000 credit, constituting a net price of $358,000, was to be paid in installments of $100,000 at the closing, and the balance in five consecutive annual installments. The first installment after the closing was to be $43,200, with four remaining installments of $53,700, plus interest at 6%. If Delores Kramer elected to redeem her shares, her[115] stock was to be purchased at the same per-share price payable in two installments of $40,000, on the sixth and seventh anniversaries of the closing, plus interest at 6% after five years.

The agreement provided that the $100,000 payment for Kramer's shares was to be funded by a life insurance policy on Kramer's life. Upon Kramer's death, MKS received the $100,000 proceeds from the life insurance policy, and it was reflected in MKS's retained earnings as of December 31, 1976.

The agreement also provided that if MKS did not have sufficient surplus or retained earnings to purchase the deceased shareholder's stock, the parties would contribute the necessary capital to enable MKS to lawfully redeem the decedent's shares. It was also agreed that the parties would be entitled to specific performance of the agreement.

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[114] The $50,000 credit was funded by a group life insurance policy paid to Kramer's beneficiary.

[115] S.Ct. petition for review pending.

After Kramer's death, Delores Kramer indicated a reluctance to have MKS redeem the shares owned by her husband's estate. Neimark insisted that MKS redeem the estate's shares, and on May 23, 1977, the board of directors met to consider Neimark's demand. The MKS attorney who was the author of the stock redemption agreement was present at this meeting and explained to the board that redemption of the stock by MKS would violate sec. 180.385(1), Stats.[116] The board voted 3-1 not to purchase the Kramer estate's shares. Neimark, of course, cast the losing vote.

On November 30, 1978, Neimark commenced an action for specific performance of the 1976 agreement and alternatively, sought monetary damages. The first claim was derivative on behalf of MKS, pursuant to sec. 180.405, Stats; the second claim was personal.

Subsequently, a third party offered to purchase the business for $1,000,000. Neimark conditioned his approval of the sale on the requirement that Delores Kramer and the Kramer estate receive proceeds equal only to the redemption price of the shares which was substantially less than the tendered per-share price. The defendants counterclaimed in Neimark's action and sought an order declaring that Neimark was entitled to receive only his ratable share of the proceeds of any sale of the business, which denied him the redemption agreement benefits. The trial court dismissed Neimark's personal claim, but ordered specific performance of the stock redemption agreement under the derivative claim. The counterclaim was dismissed.

Defendants present three issues for our consideration:

(1) did the failure to perform the stock redemption agreement cause injury to the corporation sufficient to provide a basis for the shareholder's derivative claim;

(2) did the trial court correctly conclude that MKS could lawfully redeem the estate's shares under secs. 180.385(1), 180.02(11), and 180.02(14), Stats; and

(3) would specific performance of the redemption agreement be inequitable?

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[116] Section 180.385(1), Stats., provides:

180.385 Right of corporation to acquire and dispose of its' own shares.

(1) Unless otherwise provided in the articles of incorporation, a corporation shall have the right to purchase, take, receive, or otherwise acquire, hold, own, pledge, transfer, or otherwise dispose of its own shares; provided that no such acquisition, directly or indirectly, of its own shares for a consideration other than its own shares of equal or subordinate rank shall be made unless all of the following conditions are met:

(a) At the time of such acquisition the corporation is not and would not thereby be rendered insolvent;

(b) The net assets of the corporation remaining after such acquisition would be not less than the aggregate preferential amount payable in the event of voluntary liquidation to the holders of shares having preferential rights to the assets of the corporation in the event of liquidation; and

(c) 1. Such acquisition is authorized by the articles of incorporation or by the affirmative vote or the written consent of the holders of at least a majority of the outstanding shares of the same class and of each class entitled to equal or prior rank in the distribution of assets in the event of voluntary liquidation; or

2. Such acquisition is authorized by the board of directors and the corporation has unreserved and unrestricted earned surplus equal to the cost of such shares. . . . .

I.
INJURY OR WRONG TO MKS

A fundamental requirement of a stockholder's derivative action is an injury or wrong to the corporation. . . . In the context of this case, we view the existence of injury or wrong to MKS as a question of mixed fact and law. The trial court found that the failure of MKS to perform its agreement to redeem the Mel Kramer stock constituted an injury to MKS, because such conduct neglected to take advantage of a $50,000 credit upon the purchase price of the stock, and hazarded the prospect of acquisition of the stock by outsiders. We observe that such omission also sacrificed the utilization of the financial advantage to MKS of acquisition of the stock over a five-year period at a low interest rate.

The trial court's findings are basically grounded upon the terms of the stock redemption agreement. Since that evidence is undisputed and not in conflict with other evidence, we need not accord special deference to those findings. Nonetheless, we are in complete agreement with the trial court's conclusion that failure to perform the agreement resulted in economic injury to the corporation.[117]

II.
LAWFULNESS OF REDEMPTION,
SECS. 180.385(1) and 180.02(11) and (14), STATS.

Section 180.385(1), Stats., prohibits, inter alia, acquisition by a corporation of its own stock if the corporation would thereby be rendered insolvent. "Insolvent" is defined in sec. 180.02(14) as the "inability of a corporation to pay its debts as they become due in the usual course of its business." The purpose of prohibiting own stock acquisition by a corporation if it would thereby be rendered insolvent is to protect the creditors, preferred security holders,[118] and in some cases, common stockholders whose stock is not acquired, from director action which would strip funds from the corporation and create a distributive preference to the stockholder whose stock is acquired.

In the context of this case, we view the question of whether MKS would be rendered insolvent by performance of the stock redemption agreement as a mixed question of law and fact. To the extent that the evidence with respect to factual matters is in conflict, we defer to the factual determination by the trial court unless we find it contrary to the great weight and clear preponderance of the evidence. . . .

The trial court's finding of fact, that performance of the stock redemption agreement would not render the corporation insolvent, is supported by ample evidence, and is not contrary to the great weight and clear preponderance of the evidence. The evidence establishes the fact that the corporation had the ability to pay its debts as they became due. In arriving at that

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[117] Appellants contend in their reply brief that the matters for our determination present questions of law "(w)ith but one exception," and refer us to Part 1(c) of that brief. In Part 1(c), appellants contend that the trial court committed an error of law.

[118] There are no holders of preferred security interests in MKS.

conclusion, the trial court is not restricted to analyzing the cash and cash-equivalent assets of the corporation. The flow of cash to maintain solvency can be generated by a multitude of means other than cash generated solely from sales.

In this case, MKS had a $275,000 line of credit with a local bank. Its annual financial statements for 1976, 1977, and 1978, and the May 31, 1979, financial statement, disclose no inability of MKS to pay its debts as they became due if the redemption agreement had been performed.

Upon Kramer's death, it became the obligation of MKS to redeem his stock, provided the corporation could comply with sec. 180.385(1), Stats., with respect to solvency. We agree with the trial court's finding of fact that it could. To the extent that the finding also constitutes a conclusion of law, we also agree.

Contrary to the English rule, American courts at common law generally permit a corporation to acquire its own shares.[119] The American rule has undergone harsh criticism because of the opportunity it affords to prefer selected stockholder/sellers and strip funds from the corporation to the disadvantage of preferred security interest holders, other common stockholders, and creditors. The rule sought protection for those persons by vaguely requiring that the purchase be "without prejudice" to their interests. . . Additional statutory restrictions resulted and culminated in the two major restraints (for the purposes of this case): the purchase must be made out of earned surplus and cannot be made if insolvency, in the equity sense, is present or would result. "(I)nsolvency in the equity sense has always meant an inability of the debtor to pay his debts as they mature. Under the Bankruptcy Act it means an insufficiency of assets at a fair valuation to pay the debts." *Finn v. Meighan, 325 U.S. 300, 303, 65 S.Ct. 1147, 1149, 89 L.Ed. 1624 (1945)*. The surplus and insolvency tests were incorporated in s 6 of the Model Business Corporation Act which formed the basis of the revision of the Wisconsin Business Corporation Law in the early 1950's. Section 180.385, Stats., adopts surplus and insolvency tests. Purchase of shares is permitted if: "At the time of such acquisition the corporation is not and would not thereby be rendered insolvent." Sec. 180.385(1)(a), Stats.

The self-evident applicability of the insolvency test at the time of acquisition of the stock is not equally self-evident in the case of an installment purchase. Considerations of "corporate flexibility" in the acquisition of its stock for legitimate purposes, balanced by "protection for creditors," led the majority of American courts to apply the insolvency test contemporaneously with each installment payment. The Model Business Corporation Act s 6 has been amended to specifically so provide. Although that specific change has not been incorporated in sec. 180.385(1)(a), Stats., we agree with the reasoning of the majority of American courts that the protection of the corporation's creditors requires that the insolvency

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[119] The cases constituting the American majority rules we have referred to and applied are collected and analyzed in several scholarly and exhaustive treatments of the subject: Hartmann and Wilson, Payment For Repurchased Shares Under The Texas Business Corporation Act, 26 Sw.L.J. 725 (1972); Herwitz, Installment Repurchase of Stock: Surplus Limitations, 79 Harv.L.Rev. 303 (1965); Kessler, Share Repurchases Under Modern Corporation Laws, 28 Fordham L.Rev. 637 (1959-60); Kummert, The Financial Provisions of the New Washington Business Corporation Act, Part III, 43 Wash.L.Rev. 337 (1967-68).

limitation be applied both at the time of purchase and when each installment payment is made pursuant to the purchase agreement. When the payment is actually made, the assets leave the corporation and concomitantly the loss of financial protection occurs. If insolvency results or would result, the purchase may constitute a fraudulent conveyance. In any event, the hazard of fraud to creditors is too great to permit the insolvency test to be applied at times remote to payment for the share repurchase.

Section 180.385(1)(a), Stats., recognized the problem inherent in the single application of the insolvency test and achieved flexibility by prohibiting a purchase resulting in a corporation that "is" insolvent or "would . . . be" rendered insolvent. Thus, flexibility is achieved by the statute in its application of the insolvency test to each purchase payment.

When applying the insolvency test at the stage of each payment for a stock repurchase to achieve creditor protection, consistency suggests that the amount of each payment, not the total purchase price, should be a component of the determination of solvency. The weight of authority has so applied the tests and we adopt that method of application. That method is in accord with the equity sense insolvency test expressly prescribed by secs. 180.02(11) and 180.385(1)(a), Stats.

Defendants have not demonstrated insolvency in the equity sense to the trial court or to us. Our review of the corporate financial statements in evidence discloses no arguable claim of insolvency in the equity sense. The only claim of MKS's insolvency made by defendants is premised upon a deduction of the total stock redemption[120] purchase price from the corporate assets, thereby creating a balance sheet negative net worth, although the installment payments of the purchase price are spread over five years. We reject the argument because it applies a bankruptcy rather than equity insolvency test, and is contrary to secs. 180.02(11) and 180.385(1)(a), Stats.[121]

The second limitation upon the corporate repurchase of its stock pertinent to this case is the restriction that "the corporation has unreserved and unrestricted earned surplus equal to the cost of such shares." Sec. 180.385(1)(c)2., Stats.[122] In this respect, the Wisconsin Business Corporation Law generally follows its paradigm, the Model Business Corporation Act. Earned surplus is defined in sec. 180.02(11).[123] In this case, the parties do not dispute the amount of earned surplus.

Our review of the record again establishes the following undisputed evidence with respect to paid-up capital stock, retained earnings, and total stockholders' equity.

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[120] S.Ct. petition for review pending.

[121] The modernized corporation statutes of Maryland, North Carolina, and Texas apply a bankruptcy insolvency test in addition to an equity insolvency test.

[122] We have assumed the applicability of this section because the corporation executed the agreement and this action seeks to compel the board of directors to perform the agreement. The agreement itself applies a corporate surplus test.

[123] For the purpose of this case, earned surplus can be considered to be the retained earnings of the corporation.

	12/31 1976	**12/31 1977**	**12/31 1978**	**5/31 1979**
Paid-up Capital Stock	69,400	69,400	69,400	69,400
Retained Earnings	246,409	276,073	317,586	317,584
Current Earnings				31,575
Stockholders' Equity	315,809	345,473	386,986	418,559

We subtract projected payments pursuant to the stock redemption agreement.

Retained and Current Earnings Adjusted to Reflect Deducted Installment Payments	276,073	217,586	205,961
Installment Payments Without Interest	100,000	43,200	53,700
Net Retained Earnings	176,073	174,386	152,261
Credit	50,000		

Historically, the statutory insolvency cutoff test evolved from the "no prejudice to creditors" rule. Dissatisfaction with the limited effectiveness of that test resulted in the formulation of the surplus cutoff test to be applied in conjunction with the insolvency cutoff test.

The same problem arose with the application of the surplus cutoff test that developed in applying the insolvency cutoff test: in the case of an installment purchase, should the surplus test be applied at the time of purchase or at the time cash payment is made? Most cases demonstrate little effort to distinguish between the methods of applying both tests and resolve the question by the easier and more convenient method of applying both tests in the same fashion.

* * * *

Professor Herwitz discusses a number of reasons for applying the surplus to the time of purchase rather than at each installment payment.[124] We agree with his view that the statutory surplus cutoff rule should be applied only once, and at the time of purchase, for the following reasons:

(1) unlike the equity insolvency test, a surplus test does not center upon current liabilities;

(2) unlike the application of the insolvency test, the surplus test is analogous to a purchase for cash and a loan of the unpaid cash price back to the corporation;

(3) installment application of the surplus test could bar performance of a valid obligation of the corporation to the selling stockholder but permit the corporation to disburse funds to current stockholders;

(4) the statutory requirement that surplus be restricted by such a purchase agreement could be frustrated by a construction that would require restriction only on an installment-by-installment basis and permit distributions to shareholders even though the surplus was insufficient to consummate the purchase agreement;

(5) in the manner described in (4), a limited amount of surplus could be used to justify the purchase of an unlimited amount of stock;

(6) when applied to installment payments, the surplus test could be continued indefinitely with current stockholders receiving distributions, putting the selling stockholder in limbo without the status of either creditor or stockholder;

(7) if a default in an installment is compelled by the surplus test, the selling stockholder could possibly obtain[125] a windfall return of all of stock, including the part for which payment had already been made;

(8) a creditor with knowledge of the purchase agreement could be unprotected by installment application of the statutory surplus test limitation . . . .

(9) if interest has been deducted in computing corporate net income, application of the surplus test upon an installment basis to the interest on the purchase price is unsupportable because it would take interest into account twice;

(10) the unpaid selling stockholder is given no consideration, at least to the extent of undistributed surplus, over the other stockholders who are the beneficiaries of the stock purchase; and

(11) the application of the surplus cutoff test at the outset of an installment purchase would in no way hamper or alter the installment application of the equity insolvency test.

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[124] See note 5, supra.

[125] S.Ct. petition for review pending.

We consider it a futile exercise to attempt to ground our decision upon the subtleties and nuances of semantic lexicography in defining "purchase," "acquisition," and the other acquisitory words of transfer used in the statute. The above reasons persuade us that the application of the surplus cutoff test is required to be timed to the purchase rather than the payment of cash. Such a construction comports with the need for corporate flexibility in acquiring its own stock for legitimate purposes and the protection of creditors and holders of other securities of the corporation.

* * * *

Although it is apparent from the MKS financial statements that application of the surplus cutoff test upon an installment basis would not have precluded specific performance as ordered by the trial court, application of the test at the outset will preclude specific performance upon the basis of the facts as presented to us. However, we note that the stock redemption agreement provides:

> (f) Insufficient Corporate Surplus. If the Corporation does not have sufficient surplus or retained earnings to permit it to lawfully purchase all of such shares, each of the parties shall promptly take such measures as are required to reduce the capital of the Corporation or to take such other steps as may be necessary in order to enable the Corporation to lawfully purchase and pay for the Decedent's shares.

We vacate the judgment of the circuit court and remand for further proceedings consistent with this opinion. The circuit court is directed to apply the surplus cutoff test to the time of specific performance of the stock redemption agreement if it concludes that the evidence justifies specific performance. Because we adopt an application of the statute which has not heretofore been explicated, we think it fair to permit the parties to offer current financial data with respect to MKS and the ability of the parties to the redemption agreement to take the necessary steps to enable the corporation to lawfully purchase and pay for the redeemed stock. Such evidence will enable a current evaluation of the propriety of specific performance. In the event the trial court deems specific performance appropriate, it shall make the necessary findings and requirements with regard to providing sufficient earned surplus and assuring solvency as a condition to specific performance.

We reject the defendants' claim of applicability of the business judgment rule[126] to the facts of this case. That rule accords judicial deference to a business judgment but is generally applicable to acquisition of a corporation's own stock where the board of directors has authorized the acquisition without approval of the stockholders, unlike the present circumstance where all of the stockholders consented and bound themselves to the stock redemption agreement.

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[126] See, e. g., Steven v. Hale-Haas Corp., *supra, 249 Wis. at 221, 23 N.W.2d at 628.*

III.
ALLEGED INEQUITY OF SPECIFIC PERFORMANCE OF THE REDEMPTION AGREEMENT

Defendant Delores Kramer claims that enforcement of the stock redemption agreement would be inequitable. We disagree. The requirement of adequate surplus at purchase will provide a restricted surplus account to the extent of the unpaid balance of the purchase price. It is true that she becomes a creditor of the corporation and is subject to the hazard of a business failure. She also received the benefit of a compelled market for her stock, had she desired to liquidate her interest in MKS. Her predecessor owner executed the agreement which expressly provided for specific performance. The transaction by its terms made the seller a creditor of the business. Obviously Mel Kramer thought the agreement fairly balanced the corporate obligation to acquire the stock with the owner's opportunity to liquidate an investment in a corporation whose majority stockholder and principal officer had died.

Judgment vacated and cause remanded for further proceedings consistent with this opinion.

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Chapter 7

INVESTMENTS BY THE ISSUER OF SECURITIES – ACQUISITIONS

§ 7.02 DUTIES OWED TO AND RIGHTS OF THE SECURITY HOLDERS OF THE ACQUIRED CORPORATION SECURITIES EXCHANGE ACT

page 812: Insert the following above CHROMALLOY AMERICAN CORP. v. SUN CHEMICAL CORP.

Section 13

(d)(1) Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to Section 12 of this title . . . or otherwise becomes or is deemed to become a beneficial owner of any of the foregoing upon the purchase or sale of a security-based swap that the Commission may define by rule, and is directly or indirectly the beneficial owner of more than five per centum of such class shall, *within ten days* after such acquisition *or within such shorter time as the Commission may establish by rule*, file with the Commission, a statement containing such of the following information, and such additional information, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors:

(A) The background, and identity, residence, and citizenship of, and the nature of such beneficial ownership by, such person and all other persons by whom or on whose behalf the purchases have been or are to be effected;

(B) The source and amount of the funds or other consideration used or to be used in making the purchases . . . .

(C) If the purpose of the purchases or prospective purchases is to acquire control of the business of the issuer of the securities, any plans or proposals which such persons may have to liquidate such issuer, to sell its assets to or merge it with any other persons, or to make any other major change in its business or corporate structure;

(D) The number of shares of such security which are beneficially owned, and the number of shares concerning which there is a right to acquire, directly or indirectly, by: (i) such person, and (ii) by each associate of such person, giving the background, identity, residence, and citizenship of each such associate; and

(E) Information as to any contracts, arrangements, or understandings with any person with respect to any securities of the issuer, including but not limited to transfer of any of the securities, joint ventures, loan or option arrangements, puts or calls, guaranties of loans, guaranties against loss or guaranties of profits, division of losses or profits, or the giving or withholding of proxies, naming the persons with whom such contracts, arrangements, or understandings have been entered into, and giving the details thereof.

(2) If any material change occurs in the facts set forth in the statement filed with the Commission, an amendment shall be filed with the Commission, in accordance with such rules

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and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(3) When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a *"person"* for the purposes of this subsection.

(4) In determining, for purposes of this subsection, any percentage of a class of any security, such class shall be deemed to consist of the amount of the outstanding securities of such class, exclusive of any securities of such class held by or for the account of the issuer or a subsidiary of the issuer.

(5) The Commission, by rule or regulation or by order, may permit any person to file in lieu of the statement required by paragraph (1) of this subsection or the rules and regulations thereunder, a notice stating the name of such person, the number of shares of any equity securities subject to paragraph (1) which are owned by him, the date of their acquisition and such other information as the Commission may specify, if it appears to the Commission that such securities were acquired by such person in the ordinary course of his business and were not acquired for the purpose of and do not have the effect of changing or influencing the control of the issuer nor in connection with or as a participant in any transaction having such purpose or effect.

(6) The provisions of this subsection shall not apply to:

(A) Any acquisition or offer to acquire securities made or proposed to be made by means of a registration statement under the Securities Act of 1933;

(B) Any acquisition of the beneficial ownership of a security which, together with all other acquisitions by the same person of securities of the same class during the preceding 12 months, does not exceed two per centum of that class;

(C) Any acquisition of an equity security by the issuer of such security;

(D) Any acquisition or proposed acquisition of a security which the Commission, by rules or regulations or by order, shall exempt from the provisions of this subsection as not entered into for the purpose of, and not having the effect of, changing or influencing the control of the issuer or otherwise as not comprehended within the purposes of this subsection.

Rule 13d-1. Filing of Schedules 13D and 13G.

(a) Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is specified in paragraph (i) of this Rule 13d-1, is directly or indirectly the beneficial owner of more than five percent of the class shall, *within 10 days after the acquisition*, file with the Commission, a statement containing the information required by Schedule 13D.

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Rule 13d-2. Filing of Amendments to Schedule 13D or 13G.

(a) If any material change occurs in the facts set forth in the Schedule 13D required by Rule 13d-1(a), including, but not limited to any material increase or decrease in the percentage of the class beneficially owned, the person or persons who were required to file the statement shall promptly file or cause to be filed with the Commission an amendment disclosing that change. An acquisition or disposition of beneficial ownership of securities in an amount equal to one percent or more of the class of securities shall be deemed *"material"* for purposes of this Rule 13d-1; acquisitions or dispositions of less than those amounts may be material, depending upon the facts and circumstances.

Corporate Governance Update: 13(d) Reporting Inadequacies
in an Era of Speed and Innovation

David A. Katz & Laura A. McIntosh, N.Y.L.J. September 24, 2015 at 5.

The Securities and Exchange Commission and other market regulators confront a challenging issue: How to effectively monitor and regulate activity in an environment that is both fast-moving and highly complex? The principles and architecture of the Securities Exchange Act of 1934 were created for a much simpler financial world—an analog world—and they struggle to describe and contain the digital world of today. The lightning speed of information flow and trading, the constant innovations in financial products, and the increasing sophistication of active market participants each pose enormous challenges for the SEC; together, even more so. The ongoing controversy over Section 13(d) reporting exemplifies the many challenges facing the SEC in this regard.

In 2011, then-SEC Chair Mary L. Schapiro announced a broad review of the beneficial ownership rules governing the ownership reporting requirements for equity securities.[127] The SEC had been formally petitioned that year to update the Schedule 13D reporting requirements to shorten the reporting window—specific authority for which had been provided by the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010—and broaden the definition of beneficial ownership.[128] Unfortunately, Section 13(d) reform was delayed by the overwhelming volume of rulemaking required under Dodd-Frank.[129] A recent letter to Congress signed by several ethics and watchdog groups renewed the call for intervention by lawmakers on this

[127] Chairwoman Mary L. Schapiro, "Remarks at the Transatlantic Corporate Governance Dialogue, U.S. Securities & Exchange Commission, Wash. D.C., Dec. 15, 2011, available at www.sec.gov/news/speech/2011/spch121511mls.htm.

[128] Wachtell, Lipton, Rosen & Katz, Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934, Mar. 7, 2011, available at www.sec.gov/rules/petitions/2011/petn4-624.pdf.

[129] *See* Michael Siconolfi & Susan Pulliam, "SEC Is Urged To Shorten Window for Investor Tip-Offs," Wall St. J., Mar. 27, 2014, available at http://www.wsj.com/articles/SB10001424052702304688104579465661917560346.

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important issue.[130] Though the requirements of Section 13(d) related to the timing of required disclosure unfortunately appear unlikely to be revised in the near future,[131] the SEC appears to be keenly aware of the rules' regulatory shortcomings. The SEC announced eight settlements of Section 13(d) enforcement actions in March 2015, and it is reportedly investigating a number of situations in which activist funds appear to have informally coordinated their market activity. Section 13(d) is an essential tool for promoting transparency and market integrity. While judicious enforcement in the short term may be helpful, comprehensive reform should be accomplished as soon as practicable.

* * * *

Reporting Is Not Timely or Thorough

The reporting regime under Section 13(d) of the Securities Exchange Act is, as it stands, woefully inadequate. Section 13(d) fails to require timely or thorough disclosure. In a world of instant information, the deadline for filing a Schedule 13D remains 10 calendar days *after* crossing the 5 percent ownership threshold.[132] This window is large enough for material developments to occur in secret, undermining the regulatory goals of investor protection and market efficiency. Exacerbating this issue is the fact that the investor can continue to make acquisitions during the 10-day period even after crossing the 5 percent ownership threshold Hedge funds and other activists have, in recent years, used this gap to accumulate large positions and gather support among fellow investment funds. The target company, the other shareholders, and the market have been none the wiser until the activists had amassed positions and influence well in excess of 5 percent. Though the 5 percent threshold is recognized as an important trigger for market disclosure, the 10-day window permits accumulators to continue acquiring additional shares without the market price reflecting the impact of such accumulation.

Clearly, technological advances have made short filing deadlines practical and desirable. Moreover, since crossing the 5percent threshold is rarely a surprise to the beneficial owner of the securities, there is no reason that the Schedule 13D cannot be prepared in advance and filed almost immediately upon acquisition of the reportable interests. Currently, if there is a material change to a Schedule 13D, an update must be filed "promptly," which—at least when the material change involves 1 percent or more of the subject securities—is generally understood to mean within one or two business days, and in many circumstances, the SEC staff's view has been that disclosure should be made the same day as the triggering event. There is no reason that the initial report cannot be filed within one or two business days as well. Delaware Supreme Court Chief Justice Leo Strine Jr., speaking at a conference in March 2015, added his voice to

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[130] Letter from Citizens for Responsibility and Ethics in Washington, Government Accountability Project, & New Rules for Global Finance to Hon. Richard Shelby, Chairman, & Hon. Sherrod Brown, Ranking Member, U.S. Senate Committee on Banking, Housing, & Urban Affairs; Hon. Jeb Hensarling, Chairman, & Hon. Maxine Waters, Ranking Member, U.S. House Committee on Financial Services, Apr. 15, 2015, available at www.citizensforethics.org/page/-/PDFs/Legal/Letters/4-15-15-10 Day Rule Banking Letter.pdf?nocdn=1.

[131] *See* Liz Hoffman, "SEC Unlikely to Touch 13(D) Stock-Buying Window," Wall St. J., Oct. 2, 2014, available at blogs.wsj.com/moneybeat/2014/10/02/sec-unlikely-to-touch-13d-stock-buying-window/.

[132] 17 CFR § 240.13d-1.

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those calling for reform of Section 13(d). Chief Justice Strine recommended requiring "real time" disclosures, possibly within 24 hours, as well as reducing the stock ownership threshold to 2 percent and including options and derivatives in the required disclosures.[133]

* * * *

In March 2015, the SEC announced eight settlement orders in enforcement actions against corporate insiders in connection with three going private transactions.[134] Each of the individuals was charged based on their failure to file timely amendments to their Schedule 13D filings as their plans for the transactions developed. The SEC staff in the Office of Mergers and Acquisitions discovered the violations in the course of their review of the proxy and Schedule 13E-3 transaction statements that were filed in furtherance of the transactions, months or even years later. These settlement orders (which resulted in cease-and-desist orders and payment of civil penalties, to which the individuals consented) indicate two things of note. First, the SEC is increasingly scrutinizing Section 13(d) disclosures. Though actual amendment may not be on the near horizon, the SEC appears to be tightening enforcement of the rules as they exist and indicating to market participants that disclosures will be carefully reviewed—where possible, with the benefit of hindsight. Schedule 13D filers should keep in mind that their disclosures may be evaluated in the context of additional disclosures that are made by other filers, for other purposes, and at a much later date.

The second takeaway from the March 2015 settlement orders is that the scope of disclosure required in an amendment to a Schedule 13D may be effectively broadening. It had previously been understood that 13D filers did not have to amend the generic disclosures in their initial filings until a definite plan had been formulated. Though the recent SEC orders do not provide a bright-line test, it seems that disclosure relating to the formulation of a plan may be required, and possibly disclosure of the steps taken toward determining whether or not to proceed with the formulation of a plan, particularly if they represent a change from the initial or prior disclosure. The orders indicate that although in some cases even discussions with other parties could trigger disclosure, the formation of a "group" for Section 13(d) purposes will still require actual agreement between the parties.[135] It is important to note, however, that under the rules, such an agreement need not be written; an oral or even tacit agreement would require disclosure.

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[133] *See* David Benoit & Liz Hoffman, "Taking Sides on Activist Investors," Wall St. J., Mar. 19, 2015, available at www.wsj.com/articles/strine-urges-closing-of-10-day-investment-disclosure-window-1426791548; see *also* Leo E. Strine Jr., Essay, "Can We Do Better By Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law," 114 Columbia L. Rev. 449, 493-96 (2014) available at http://columbialawreview.org/can-we-do-better-by-ordinary-investors-a-pragmatic-reaction-to-the-dueling-ideological-mythologysts-of-corporate-law/.

[134] Securities & Exchange Commission, Press Release, Mar. 13, 2015, "Corporate Insiders Charged for Failing To Update Disclosures Involving 'Going Private' Transactions," available at www.sec.gov/news/pressrelease/2015-47.html.

[135] For a more detailed discussion, see David A. Katz & Alison Z. Preiss, "SEC Charges Schedule 13D Filers for Failing To Timely Disclose Steps Taken To Pursue Going-Private Transactions," Wachtell, Lipton, Rosen & Katz Client Memo, Mar. 17, 2015, available at www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.23896.15.pdf.

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The SEC's focus on Section 13(d) disclosures is a welcome development, with two important caveats. First, increased enforcement is not a substitute for meaningful reform; thoughtful and thorough revision of the requirements of Section 13(d) will be far more effective in promoting transparency and compliance. Second, the scope of securities regulation is meant to be expanded through the administrative rulemaking process, not through zealous enforcement. To the extent that the SEC's scrutiny and administrative proceedings begin to shift the line separating acceptable and impermissible conduct—which may be happening in the context of Schedule 13D amendments, as indicated by the SEC orders discussed above—newly vigorous enforcement might arguably raise due process issues.[136] While efforts by the SEC to promote full and prompt compliance with the beneficial ownership disclosure requirements will help to enhance their value as a meaningful source of information, their relevance to the market will be necessarily limited until comprehensive reform can be accomplished and fully implemented.

* * * *

Page 882: insert the following after Weinberger v. UOP, INC.

IN RE KENNETH COLE PRODS., INC SHAREHOLDER LITIGATION
New York Court of Appeals
2016 WL 2350133

STEIN, J.:

In this shareholder class action challenging a going-private merger, we adopt the standard of review recently announced by the Delaware Supreme Court in *Kahn v. M & F Worldwide Corp.*, *(88 A3d 635, 648-649 [Del 2014]) (MFW)*. Specifically, in reviewing challenges to going-private mergers, New York courts should apply the business judgment rule as long as certain shareholder-protective conditions are present; if those measures are not present, the entire fairness standard should be applied. Applying the MFW standard to the case before us, we affirm the dismissal of the complaint.

I.

Kenneth Cole Productions, Inc. (KCP) is a New York corporation that designs and markets apparel, footwear, handbags and accessories. KCP was organized with two classes of common stock. As of June 2012, there were approximately 10,706,723 outstanding shares of Class A stock, which were traded on the New York Stock Exchange. Each Class A share entitled the holder to one vote, and defendant Kenneth D. Cole held approximately 46% of these shares. As of June 2012, there were approximately 7,890,497 outstanding shares of Class B stock, all of which were held by Cole. Class B shares entitled the holder to 10 votes, giving Cole approximately 89% of the voting power of the KCP shareholders. At the time in question, KCP's board of directors consisted of Cole and the other individual defendants herein. Defendants Michael J. Blitzer and Philip R. Peller were elected by Class A shareholders.

[136] SEC Commissioner Michael S. Piwowar addressed this subject in a 2014 speech. See SEC Commissioner Michael S. Piwowar, Remarks to the Securities Enforcement Forum, Oct. 14, 2014, available at http://www.sec.gov/News/Speech/Detail/Speech/1370543156675.

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Notably, defendants Denis F. Kelly and Robert C. Grayson held directorships voted on by both Class A and Class B shareholders, effectively giving Cole sole authority to fill these positions.

At a meeting held in February 2012, Cole proposed a going-private merger by informing KCP's board of his intention to submit an offer to purchase the remainder of the outstanding Class A shares and, in effect, take the publicly-traded company private. After making this announcement, Cole left the meeting, and the board established a special committee to consider the proposal and negotiate any potential merger. The special committee consisted of directors Grayson, Kelly, Blitzer and Peller. On February 23, 2012, Cole made an initial offer of $15.00 per share. The offer was conditioned on approval by (1) the special committee, and, then, (2) a majority of the minority shareholders. At that time, Cole indicated that he had no desire to seek any other type of merger and, as a stockholder, would not approve of one. He also stated that, if the special committee did not recommend approval or the stockholders voted against the proposed transaction, his relationship with KCP would not be adversely affected.

Within a few days of Cole's announcement, several shareholders, including plaintiff Erie County Employees Retirement System, commenced separate class actions alleging, among other things, breach of fiduciary duty by Cole and the directors. The committee retained legal counsel and a financial advisor, and proceeded to negotiate the terms of the going-private merger with Cole. The committee asked Cole to increase his offer several times, which he ultimately raised to $15.50 and then $16.00. Within a week of the $16.00 offer, Cole reduced his offer to $15.00, citing the alleged recent emergence of problems in the company and the economy. Finally, after months of negotiations, the special committee again asked Cole to increase his offer and, thereafter, approved Cole's offer of $15.25 for each outstanding share of Class A stock, which it recommended to the minority shareholders. Although the shareholder vote apparently occurred after an amended complaint was filed in this action,[137] and is not mentioned therein, 99.8% of the minority shareholders voted in favor of the merger.

In the amended complaint, plaintiff sought, among other things, (1) a judgment declaring that Cole and the directors had breached the fiduciary duties they owed to the minority shareholders, (2) an award of damages to the class, and (3) a judgment enjoining the merger. Defendants separately moved to dismiss the complaint on the ground that it failed to state a cause of action.

Supreme Court granted defendants' motions and dismissed the complaint. The court determined that the complaint "fail[ed] to set forth facts demonstrating a lack of independence on the part of any of the . . . individual defendants." Further, the court held that "the complaint d[id] not adequately allege any facts that, if true, demonstrate[d] that the decision not to seek other bids constituted a breach of fiduciary duty," as "plaintiff[ ] acknowledge[d] that the special committee negotiated with Cole over a period of months and obtained an increase in the price he would pay . . . where the original price represented a premium over the stock's most recent selling price." Ultimately, the court reasoned that, "absent a showing of specific unfair conduct

[137] After the special committee recommended that Cole's $15.25 offer be accepted, plaintiff amended its complaint to reflect what had occurred since the action was commenced. This action was ultimately consolidated with five other class actions.

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by the special committee, the [c]ourt will not second guess the [special] committee's business decisions in negotiating the terms of [the] transaction." The court further held that "the complaint d[id] not contain adequate statements regarding a breach" of Cole's fiduciary duty. Plaintiff appealed, on behalf of itself and the class.

The Appellate Division affirmed, holding that, "[c]ontrary to plaintiff's claim, the motion court was not required to apply the 'entire fairness' standard to the transaction" (122 AD3d 500, 500 [1st Dept 2014]). The Court noted that, unlike in *Alpert v. 28 Williams St. Corp.*, *(63 N.Y.2d 557 [1984]),* "the merger in the case at bar required the approval of the majority of the minority (i.e., non-Cole) shareholders" (122 AD3d at 500). In addition, Cole, an interested party, "did not participate when [KCP]'s board . . . voted on the merger," and plaintiff did "not allege[ ] that the remaining members of the board . . . were self-interested" (*id.*). The Court held that "there [were] no allegations sufficient to demonstrate that the members of the board or the special committee did not act in good faith or were otherwise interested" (*id*. at 501). This Court granted plaintiff leave to appeal . . . .

II.

The primary issue before us is what standard should be applied by courts reviewing a going-private merger that is subject from the outset to approval by both a special committee of independent directors and a majority of the minority shareholders. Plaintiff urges that we apply the entire fairness standard, which places the burden on the corporation's directors to demonstrate that they engaged in a fair process and obtained a fair price. Defendants seek application of the business judgment rule, with or without certain conditions. We are persuaded to adopt a middle ground. Specifically, the business judgment rule should be applied as long as the corporation's directors establish that certain shareholder-protective conditions are met; however, if those conditions are not met, the entire fairness standard should be applied.

We begin with the general principal that courts should strive to avoid interfering with the internal management of business corporations. To that end, we have long adhered to the business judgment rule, which provides that, where corporate officers or directors exercise unbiased judgment in determining that certain actions will promote the corporation's interests, courts will defer to those determinations if they were made in good faith . . . . The doctrine is based, at least in part, on a recognition that: courts are ill equipped to evaluate what are essentially business judgments; there is no objective standard by which to measure the correctness of many corporate decisions (which involve the weighing of various considerations); and corporate directors are charged with the authority to make those decisions (*see Auerbach v. Bennett*, *47 N.Y.2d 619, 630–631 [1979])*. Hence, absent fraud or bad faith, courts should respect those business determinations and refrain from any further judicial inquiry . . . . We have, therefore, held that the substantive determination of a committee of disinterested directors is beyond judicial inquiry under the business judgment rule, but that "the court may inquire as to the disinterested independence of the members of that committee and as to the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee"

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A freeze-out merger is typical of situations in which a director's loyalty may be divided or compromised, thereby calling into question the applicability of the business judgment rule. In such a merger, the majority stock owner or group in control attempts to freeze out the interests of minority shareholders. There are three main types of freeze-out mergers: (1) two-step mergers, in which an outside investor purchases control of the majority shares of a target company, then uses that control to merge the target with a second company, thereby freezing out the minority shareholders of the target and forcing a cash-out of their shares; (2) parent-subsidiary mergers; and (3) going-private mergers, in which the majority shareholder seeks to remove public investors and gain ownership of the entire company.

This Court's seminal decision regarding freeze-out mergers is *Alpert v. 28 Williams St. Corp.*, *(63 N.Y.2d 557 [1984])*. In that case, we recognized that, where there are common directors or majority ownership between the parties involved in a transaction, "the inherent conflict of interest and the potential for self-dealing requires careful scrutiny of the transaction" (*id*. at 570). In reviewing a two-step merger in *Alpert*, we held that while, "[g]enerally, the plaintiff has the burden of proving that the merger violated the duty of fairness, . . . when there is an inherent conflict of interest, the burden shifts to the interested directors or shareholders to prove good faith and the entire fairness of the merger" This "entire fairness" standard has two components: fair process and fair price (*see Alpert*, *63 N.Y.2d at 569–570)*. The fair process aspect concerns timing, structure, disclosure of information to independent directors and shareholders, how approvals were obtained, and similar matters . . . . The fair price aspect can be measured by whether independent advisors rendered an opinion or other bids were considered, which may demonstrate the price that would have been established by arm's length negotiations . . . . Considering the two components, the transaction is viewed as a whole to determine if it is fair to the minority shareholders . . . .

In *Alpert*, we specifically stated that we were not deciding whether the circumstances that would satisfy fiduciary duties in a two-step merger would be the same for other types of mergers . . . . Thus, that decision is not dispositive of the standard for reviewing a going-private merger, such as the one now before us. The present case is also distinguishable because, in *Alpert*, there was no independent committee and no minority shareholder vote.

The parties here debate whether we should apply the entire fairness standard, as in Alpert, or, alternatively, whether we should adopt the test recently established by the Delaware Supreme Court in *Kahn v. M & F Worldwide Corp.*, *(88 A3d 635, 648–649 [Del 2014]) (MFW)*. In *MFW*, a controlling shareholder sought to purchase all of the shares of stock and take the corporation private, but made the proposal contingent from the outset upon two shareholder-protective measures—negotiation and approval by a special committee of independent directors, and approval by a majority of shareholders that were unaffiliated with the controlling shareholder . . . . As in the case before us, the controlling shareholder also made it clear that it was not interested in selling any of its shares, would not vote in favor of any alternative sale or merger and, if the merger was not recommended, its future relationship with the company—including its desire to remain a shareholder—would not be adversely affected . . . .

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In *MFW*, the question before the Delaware Supreme Court was framed as "what standard of review should apply to a going private merger conditioned upfront by the controlling stockholder on approval by both a properly empowered, independent committee and an informed, uncoerced majority-of-the-minority vote . . . . In prior cases, the Delaware Supreme Court had applied the entire fairness standard when reviewing mergers with interested directors, although the court had created a burden shift—placing the burden on the objecting minority shareholders—in situations in which the interested director required approval by an independent committee *or* a majority of the minority shareholders . . . . Never before had that Court addressed a situation in which both of those protections were present . . . .

The Delaware Supreme Court opined in MFW that the opportunity for review under the business judgment rule—as opposed to the entire fairness standard—created a strong incentive for controlling shareholders to provide a structure for freeze-out mergers that is most likely to protect the interests of minority shareholders, because when *both* protections are in place, the situation replicates an arm's length transaction and supports the integrity of the process (*see id*. at 643). That Court ultimately held that "business judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned *ab initio* upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders" (*id*. at 644). The Court articulated a number of reasons for the adoption of this new standard, including that: where the controlling shareholder clearly disabled itself from using its control to dictate the outcome, the merger acquired the characteristics of "third-party, arm's length mergers" that are reviewed under the business judgment rule; "the dual procedural protection merger structure optimally protects the minority stockholders in controller buyouts"; it is consistent with the tradition of courts deferring to informed decisions by impartial directors, especially when approved of by disinterested and informed stockholders; and it will provide an incentive to create structures that best protect minority shareholders (*id*.). The standard was summarized as follows:

> "in controller buyouts, the business judgment standard of review will be applied *if and only if*: (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority" (*id*. at 645).

We now adopt that standard of review for courts reviewing challenges to going-private mergers. The standard set forth in *MFW* reinforces that the business judgment rule is our general standard of review of corporate management decisions judicial inquiry under the business judgment rule . . . . While the business judgment rule is deferential to corporate boards, minority shareholders are sufficiently protected by *MFW's* conditions precedent to the application of that standard in going-private mergers. Overall, the *MFW* standard properly considers the rights of minority shareholders—to obtain judicial review of transactions involving interested parties, and to proceed to trial where there is adequate proof that those interests may have affected the

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transaction—and balances them against the interests of directors and controlling shareholders in avoiding frivolous litigation and protecting independently-made business decisions from unwarranted judicial interference.

According to the Delaware Supreme Court, for purposes of this rule, a complaint is sufficient to state a cause of action for breach of fiduciary duty—and the plaintiff may proceed to discovery—if it alleges "a reasonably conceivable set of facts" showing that any of the six enumerated shareholder-protective conditions did not exist . . . .

Reviewing the complaint here under the *MFW* standard, we conclude that the courts below properly determined that the allegations do not withstand defendants' motions to dismiss. Plaintiff did not sufficiently and specifically allege that any of *MFW's* six enumerated conditions were absent from the merger here. Beginning with the first condition, plaintiff concedes that Cole conditioned the merger, from the outset, upon approval by both a special committee of independent directors and a majority of the minority shareholders.

Next, in challenging the independence of the special committee, plaintiff alleged that Cole and/or his personally selected directors were responsible for nominating and electing the committee members to KCP's board. In this regard, the question is whether a director is beholden to the controlling party or so under that party's influence that the director's discretion would be compromised (*see MFW*, *88 A3d at 648–649*). Friendships, traveling in the same circles, some financial ties, and past business relationships are not enough to rebut the presumption of independence; the ties must be material in the sense that they could affect impartiality (*see id*. at 649). None of the allegations of the complaint, even if true, indicate that any of the members of the special committee engaged in fraud, had a conflict of interest or divided loyalties, or were otherwise incapable of reaching an unbiased decision regarding the proposed merger . . . .

As to the third *MFW* condition, the complaint does not allege that the special committee lacked the freedom to reject Cole's offer or was prevented from hiring its own advisors, nor does it dispute that the committee did, in fact, select its own financial advisors and legal counsel. Plaintiff's speculation that the committee merely submitted to Cole's wishes is insufficient to state a cause of action for breach of fiduciary duty, particularly in view of Cole's statement at the time of his initial proposal that, if the committee did not recommend approval or the minority shareholders did not vote in favor of the proposed transaction, such a determination "would not adversely affect [his] . . . relationship" with KCP.

Turning to the fourth condition, while the complaint contains various allegations suggesting that the special committee could have been more effective in negotiating a higher buy-out price, none of those allegations are sufficient to support more than conclusory assertions that the committee failed to meet its duty of care in negotiating a fair price. Significantly, the complaint fails to allege any basis to conclude that the committee had an incentive to accept an inadequate price without meaningful negotiations or that it engaged in any unfair conduct. Additionally, the final price of $15.25 per share was higher than the original offer, was within the range of value determined by the committee's independent financial analysts, was recommended

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by the committee's independent legal counsel and financial advisors, and was higher than the stock's price prior to Cole's announcement that he intended to take the company private.[138]

Regarding the fifth condition, the complaint lacks any specific challenges to the information contained in, or allegedly omitted from, the proxy statement provided to the minority shareholders prior to the vote, such that it could be said that the shareholders were not informed (*see Kimeldorf*, *309 A.D.2d at 158*). Finally, plaintiff did not allege any coercion of the minority shareholders in relation to the vote.

Because plaintiff has not sufficiently alleged that any of the six enumerated MFW conditions were absent, the business judgment standard of review applies to the transaction at issue (*see MFW*, *88 A3d at 645*). Pursuant to that standard, absent fraud or bad faith, we defer to the determinations of the special committee and the KCP board of directors in recommending and approving the merger . . . . Inasmuch as no fraud or bad faith has been alleged here, the complaint was properly dismissed. . . . .

[138] Although the complaint cites rising KCP stock prices and positive financial analyses following Cole's announcement that he planned to take the company private, defendants correctly note that this information cannot be used to properly value the stock because those figures reflect an artificial increase in the price due to the prospect of the merger.