CASE COMMENTARIES

BANKRUPTCY

A bankruptcy court may not enter final judgment on claims based solely on state law that are not resolved in the process of ruling on a creditor's proof of claim. *Stern v. Marshall*, 131 S. Ct. 2594 (2011).

By Todd B. Skelton

At issue in *Stern v. Marshall* was whether a bankruptcy court has the constitutional authority to issue a final judgment on a state law counterclaim. The Supreme Court held that the bankruptcy court does not have the constitutional authority to decide a common law claim that is not resolved in the process of ruling on a creditor's proof of claim. The case arose from the saga of litigation between Vickie Lynn Marshall and E. Pierce Marshall regarding the fortune of the late Texas oil tycoon J. Howard Marshall II.

Vickie, more popularly known as Anna Nicole Smith, married J. Howard Marshall II in 1994, about one year before his death. Vickie, who was J. Howard's third wife, received many gifts from J. Howard but was not named in his will. Before J. Howard died, Vickie alleged in a Texas probate court that Pierce Marshall, J. Howard's son, fraudulently induced J. Howard to exclude her from an *inter vivos* trust despite J. Howard's alleged desire for her to inherit half of his property.

Following J. Howard's death, Vickie filed for relief under chapter 11 of the Bankruptcy Code. After alleging Vickie had defamed him by saying that he had engaged in fraud to control his father's assets, Pierce filed a proof of claim in the bankruptcy court seeking to recover damages from Vickie's bankruptcy estate. Vickie responded with a counterclaim against Pierce for tortious interference with the gift she had expected from J. Howard. The bankruptcy court granted summary judgment for Vickie on Pierce's defamation claim and later issued a judgment in Vickie's favor on her counterclaim.

Pierce disputed the bankruptcy court's jurisdictional authority over the counterclaim, but the federal district court, in an independent review of the record, found that Pierce was guilty of tortious interference with regard to Vickie's gift expectations. Notably, the district court declined to follow the Texas probate court's earlier ruling for Pierce that the trust and will were valid. The Ninth Circuit Court of Appeals then reversed the district court's finding by invoking the probate exception

to federal jurisdiction. The United States Supreme Court subsequently reversed in *Marshall v. Marshall*, 547 U.S. 293 (2006). On remand, the court of appeals held that Vickie's counterclaim was not sufficiently related to the proof of claim and found the Texas probate court's determination to be preclusive. By the time the Supreme Court granted certiorari for the second time, both Vickie and Pierce had died and their estates were continuing the litigation.

Only Article III courts may exercise the judicial power of the United States under the Constitution. Congress cannot confer judicial authority on non-Article III courts. Bankruptcy courts, however, are creatures of Congress under Article I of the Constitution. Article I judges do not enjoy the same tenure and salary protections as Article III judges. Under 28 U.S.C. § 157, bankruptcy proceedings can "arise under title 11," "arise in a case under title 11," or be "related to a case under title 11." A bankruptcy court can enter final judgments on core proceedings arising under title 11 or arising in a case under title 11. Section 157(b)(2) delineates sixteen examples of "core proceedings," including "(C) counterclaims by the estate against persons filing claims against the estate." Final judgments by a bankruptcy court in core proceedings are appealable to the district court. With the third type—a proceeding "related to a case under title 11"—the bankruptcy judge "may only 'submit proposed findings of fact and conclusions of law to the district court'" under § 157(c)(1), and the district court can enter final judgment after the opportunity for *de novo* review.

On appeal, the Supreme Court held that while the bankruptcy court had statutory authority under 28 U.S.C. § 157(b)(2)(C) to enter final judgment on the counterclaim for tortious interference, it lacked the constitutional authority to do so under Article III because the state law counterclaim was not resolved in the process of ruling upon Pierce's proof of claim. The Court first considered the grant of statutory authority under § 157. Vickie's counterclaim against Pierce for tortious interference was indeed a core proceeding because it was a "counterclaim by the estate against persons filing claims against the estate." Pierce had filed a proof of claim against Vickie's bankruptcy estate, and though the Court found ambiguous the "arising under" and "arising in" language of § 157, the bankruptcy court did have the statutory authority to enter final judgment on the counterclaim.

Next, the Court considered the constitutional aspect of the case. The Court found that the bankruptcy court "in this case exercised the 'judicial Power of the United States' in purporting to resolve and enter final judgment on a state common law claim." Because Vickie's counterclaim was a state common law claim neither arising from a federal regulatory scheme nor requiring resolution by an expert

government agency, the public rights exception that excuses compliance with Article III did not apply. In addressing the argument that the counterclaim was compulsory, the Court found that the resolution of Pierce's proof of claim would not result in resolution of Vickie's counterclaim. The Court also rejected the argument that the bankruptcy court is a "mere adjunct" of the district court. Bankruptcy courts have broad authority to resolve claims, but such authority must be within the confines of the Constitution. Exercising the "judicial power of the United States," however, is reserved for Article III courts.

Finally, the Court rejected Vickie's argument that restricting a bankruptcy court's ability to resolve counterclaims will cause delays and increase costs. Efficiency and convenience "will not save [a law] if it is contrary to the Constitution." The law "already contemplates that certain state law matters in bankruptcy cases will be resolved by judges other than those of the bankruptcy court." The majority describes their holding as a "'narrow' one," implying that not all counterclaims are barred from being heard by the bankruptcy courts. The Court will not allow "slight encroachments" to "compromise the integrity of the system of separated powers." Accordingly, the Court found that Congress exceeded its authority in this "one isolated respect" and that the "bankruptcy court below lacked the constitutional authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim." Consequently, the Supreme Court affirmed the decision of the Ninth Circuit Court of Appeals.

Two other opinions were filed. Justice Scalia's concurring opinion reiterated his opinion that public rights must arise between the government and others and also took issue with the "sheer numerosity" and "random[ness]" of the tests used to "conclude[ ] that an Article III judge was required to adjudicate this lawsuit." Justice Breyer's dissenting opinion, joined by Justices Ginsburg, Sotomayor, and Kagan, questioned the majority's weighting and analysis of precedent and, using a five-factor test, concluded that the delegation of authority was constitutional.

The 5-4 decision in *Stern v. Marshall* has generated remarkable debate and is significant for bankruptcy attorneys because of the new rule of law that bankruptcy judges do not have the authority to decide claims based solely on state law. Although the majority envisioned their holding to be narrow, this landmark decision will affect creditors whose claims in bankruptcy proceedings are based solely on state law and will likely place uncertainty on other claims traditionally decided in bankruptcy court. Bankruptcy judges still, however, have the power to hear claims

and counterclaims by debtors and creditors as long as they are related to federal law. The holding emphasizes the need for counsel to carefully consider litigation strategy, as not all core claims may be decided by the bankruptcy court. Parties must prepare for delays in waiting on other courts to decide claims, and depending on the case, claims for any number of creditors could be pending in state court, only adding to the complexity of resolving debtor-creditor issues.

BUSINESS ASSOCIATIONS

In Delaware, a creditor of an LLC who is neither a member nor an assignee of the LLC lacks standing to bring a derivative suit, and this restriction on derivative standing is constitutional. *CML V, LLC v. Bax*, 28 A.3d 1037 (Del. 2011).

By Catherine Rolen

At issue in *CML V, LLC v. Bax* was whether title 6, sections 18-1001 and 18-1002 of the Delaware Limited Liability Company Act ("LLC Act") deprive an LLC's creditors from derivative standing, and if so, whether these sections of the LLC Act are unconstitutional because they unduly restrict the Delaware Court of Chancery's equity jurisdiction. In *CML*, a creditor of an insolvent Delaware LLC brought a derivative suit against the LLC's managers for breach of fiduciary duties. However, the chancery court determined that the creditor lacked derivative standing and dismissed the case. On appeal, the Delaware Supreme Court affirmed the lower court's decision.

JetDirect Aviation Holdings, LLC ("JetDirect") was a Delaware limited liability company specializing in private jet management and chartering. In 2005, JetDirect implemented a business expansion strategy in which it acquired several small and mid-sized competitors. After implementing the expansion strategy, JetDirect became highly leveraged and began having cash flow problems. In addition, JetDirect had serious deficiencies in its internal accounting system. JetDirect's auditor informed the board and its officers of these deficiencies in 2006. Rather than address these issues, JetDirect maintained the same internal auditing practices, and the next year its new auditor refused to complete the audit because JetDirect's internal controls and accounting system were so unreliable.

Not surprisingly, JetDirect continued to have cash flow problems. Thus, in April of 2007, JetDirect acquired a $25,743,912 loan from CML V, LLC ("CML"), and CML later increased this loan to $34,243,912. Despite the fact that JetDirect's board did not have current information about the state of the company's finances due to the internal accounting deficiencies, the board continued with the expansion strategy and made four more acquisitions after receiving the loan. JetDirect defaulted on the CML loan in June of 2007, and by late 2008, JetDirect was insolvent and began liquidating its assets. According to CML, JetDirect did not repay any of the debt it owed CML even after liquidation.

CML brought a derivative suit against individual members of JetDirect's board of managers, alleging a breach of the duty of care, a breach of the duty of loyalty, and bad faith based on the board's failure to implement an effective accounting system and continuing to approve acquisitions despite not being fully informed of JetDirect's financial situation. The defendants alleged that CML lacked standing to sue derivatively because the LLC Act denied creditors derivative standing. CML countered that if the LLC Act barred creditors from suing derivatively, then the Act was unconstitutional because it encroached on the equitable jurisdiction of the court of chancery.

The two provisions at issue in *CML* are title 6, sections 18-1001 and 18-1002 of the Delaware Code. Section 18-1001 authorizes a member or assignee of an LLC to bring an action in the court of chancery on behalf of the LLC when managers or members have refused to do so. Thus, section 18-1001 permits members and assignees of LLCs to sue derivatively. Section 18-1002 limits the plaintiff in a derivative action to "a member or an assignee of a limited liability company interest at the time of bringing the action." CML argued that the two provisions read together provide members and assignees derivative standing but do not limit derivative standing only to those two groups.

On appeal, the Delaware Supreme Court held that (1) section 18-2002 of the LLC Act precludes derivative standing for an LLC's creditors, and (2) section 18-1002 is constitutional because it does not impinge on the court of chancery's equity jurisdiction. In interpreting the meaning of section 18-2002, the court looked to the plain meaning of the statute and determined that it is unambiguous and exclusively limits derivative standing to members and assignees of LLCs only. Therefore, the LLC Act bars creditors who are not assignees or members from filing a derivative suit. The court further found that reading sections 18-1001 and 18-1002 together does not yield a different result. Section 18-1001 simply creates the right to file a derivative suit on behalf of an LLC, and section 18-1002 further limits this right to assignees and members. In response to CML's argument that the General Assembly intended to extend the rule of derivative standing for corporate creditors to creditors of LLCs, the court asserted that the language in section 18-1002 clearly and unequivocally restricts derivative standing to members and assignees and any other reading would result in an absurd interpretation of legislative intent. The court noted that the General Assembly is free to govern LLCs and corporations differently since they are distinct entities, which offer a separate "bundle of rights" to investors.

Therefore, CML's contention that there should be no difference between LLCs and corporations in regard to derivative standing is erroneous.

After holding that section 18-1002 denies creditors derivative standing, the court turned to the issue of whether the LLC Act provision is constitutional. According to the court, the Delaware constitution "prohibits the General Assembly from limiting the equity jurisdiction of the court of chancery to less than the general equity jurisdiction of the High Court of Chancery of Great Britain existing at the time of [its] separation from the Mother Country." Furthermore, at common law, courts may extend *corporate* derivative standing to prevent injustice as new circumstances arise. However, the court emphasized that this extension of equity jurisdiction applies only to corporate derivative standing and not to LLC derivative standing because LLCs did not exist until 1992 when the General Assembly passed the LLC Act. Thus, the court found that the LLC Act is the only statute governing adjudication of the rights and remedies related to Delaware LLCs. Although the General Assembly included a provision in the LLC Act stating that common law equity principles supplement the LLC Act provisions, common law governs only where the LLC Act lacks a pertinent provision. Where an LLC Act provision specifically addresses a certain issue, the LLC Act supersedes the common law. In this case, there was an applicable LLC Act provision, which specifically stated that only assignees and members of LLCs have derivative standing, so the court did not need to look to a controlling common law principle to make a determination. Therefore, the court held that section 18-1002 of the LLC Act is constitutional and does not encroach on the court of chancery's constitutional jurisdiction.

CML makes it clear that creditors of Delaware LLCs do not have standing to sue derivatively, and attorneys representing a Delaware LLC's creditors should ensure that their clients negotiate terms to protect their interests in the LLC upon forming a contractual relationship. As the Delaware court suggests, a provision stating that the creditor will be converted to an assignee should the LLC become insolvent would be a prudent way to protect a creditor's interest. The outcome in *CML* demonstrates that an LLC's creditors in Delaware who do not protect their interests through contract negotiation will have limited recourse because the LLC Act bars them from suing derivatively. The case also has implications beyond the preclusion of derivative standing for creditors. The Delaware Supreme Court stresses that corporations and LLCs are distinct entities, which the General Assembly is free to govern differently, and a transactional attorney should not assume that the same common law principles that apply to corporations in Delaware also apply to

LLCs. In particular, transactional attorneys should first look to the LLC Act to determine if there is a direct provision that applies to any issue that arises during drafting or negotiations before turning to common law principles since the court clearly states that the LLC Act governs when there is an applicable provision. The distinction the court draws between the governance of corporations and LLCs is important for transactional attorneys to consider when negotiating contract terms for clients who are LLCs or for clients who transact business with Delaware LLCs.

CIVIL PROCEDURE

A resulting trust, rather than a constructive trust, is the proper equitable remedy when the element of fraud is not proven in a property transfer dispute. *Williams v. Leaver*, No. M2010-01874-COA-R3-CV, 2011 Tenn. App. LEXIS 524, 2011 WL 4477972 (Tenn. Ct. App. Sept. 27, 2011).

By Fred Pickney

In *Williams v. Leaver*, the Tennessee Court of Appeals considered whether the trial court properly imposed a constructive trust on a parcel of real property that was transferred from parents to one child with the intention that both children would share equally in the property. The court found that the trial court erred in imposing a constructive trust because the plaintiffs failed to prove fraud. However, the court found that the record contained clear and convincing evidence supporting the imposition of a resulting trust, and affirmed the trial court's judgment as modified.

In 1975, Irvin and Linda Sue Leaver ("the Leavers") purchased 5.9 acres of property in Rutherford County, Tennessee, where they later built a house. Eventually, the Leavers' two children, Wanda and Ted, both moved into mobile homes on the property. In 2002, the Leavers had a meeting with both their children regarding their desire to move to Florida. Although Ted and Wanda later disagreed about what the Leavers communicated to them at that meeting, according to Wanda, the Leavers intended for their property to be divided equally between Wanda and Ted.

In December 2002, the Leavers quitclaimed the property to Ted and his wife, Shelly, because Shelly was the only person financially qualified to assume the mortgage that the Leavers had on the house. The deed did not mention Wanda or her husband, Kevin.

In January 2005, Ted and Shelly moved into the main house, where the Leavers lived before moving to Florida. Wanda and Kevin moved into the mobile home formerly occupied by Ted and Shelly. Wanda and Kevin agreed to make installment payments to Ted and Shelly to purchase the mobile home. In 2009, Ted and Shelly sold their home and all six acres, including the mobile home, to Ted's son, Brandon, and his wife, for $150,000. Accordingly, Wanda and Kevin began making their payments to Brandon. Beginning in August 2009, Wanda and Kevin failed to make several monthly payments. Brandon filed a detainer action against Wanda and Kevin.

In November 2009, Wanda and Kevin filed a lawsuit seeking a declaratory judgment and a constructive trust with respect to the six-acre tract of property. They asserted equitable ownership in one-half of the value of the real property at issue, but sought only the two acres referenced in their agreement with Ted and Shelly regarding the purchase of the mobile home. At trial, Irvin Leaver testified (Linda Sue Leaver was deceased) unequivocally that he intended the children to share the property equally. He testified that it was his understanding that Ted and Wanda would work things out so they each would get their equal share of the property. The trial court found that the Leavers intended for their children to share equally in the property and therefore found that Brandon was holding two acres of the property subject to a constructive trust for the benefit of Wanda and Kevin.

A trial court's findings of fact are reviewed *de novo* with a presumption of correctness unless the evidence preponderates otherwise. Questions of law are also reviewed *de novo*, but with no presumption of correctness. A party asserting a constructive (or resulting) trust by parol evidence must prove the existence of the trust by clear and convincing evidence. A constructive trust is appropriate only against one who, by fraud, duress, abuse of confidence, or unconscionable conduct has obtained an interest in property which he ought not in equity or in good conscience retain. A resulting trust, however, does not require fraud or constructive fraud. A resulting trust usually arises when one person becomes invested with legal title but is obligated in equity to hold the legal title for the benefit of another. A resulting trust generally arises on a failure of an express trust or the purpose of such a trust, or on a conveyance to one person on a consideration from another.

On appeal, the Tennessee Court of Appeals held that the trial court erred in imposing a constructive trust, but that another equitable trust, a resulting trust, was proper, and affirmed the trial court's judgment as modified. The court affirmed the trial court's finding of fact crediting Irvin and Wanda's testimony that the Leavers intended for their children to share equally in the property. The evidence in the record did not preponderate against any findings of fact made by the trial court, so the findings were presumed correct. The plaintiffs did not allege fraud or any form of deceptive or unconscionable conduct by Ted and Shelly Leaver or by Brandon Leaver. Therefore, the court found that imposing a constructive trust was error.

While the elements of a constructive trust were lacking, the elements of a resulting trust were satisfied. Although the Leavers transferred the property solely to Ted and Shelly, Ted and Shelly held a portion of the property in trust for Wanda and Kevin. The meeting that the Leavers had with their children not only demonstrated

their intention for the property to be shared equally, but also put Ted and Shelly on notice of this intention. Although notice is not required for a resulting trust, notice rebuts Ted and Shelly's claim on appeal that they were bona fide purchasers and thus not subject to any equitable trust. The court imposed a resulting trust because Irvin and Wanda's testimony clearly indicated a failure of an express trust and because it would be inequitable to deny Wanda and Kevin an interest in the property.

Williams v. Leaver highlights the importance of accurately reflecting the intention of the transferor when transferring property. As this case demonstrates, informality often leads to litigation, even among family members. If Wanda and Kevin's interest had been clearly detailed in the property deed, litigation would have been unnecessary. Wanda and Kevin were fortunate that Irvin was still alive and able to testify to Linda Sue's and his intention that the property be divided equally among their children. Because the deed did not mention the Leavers' intent, Wanda and Kevin would have had difficulty proving the elements of an equitable trust to the clear and convincing standard without Irvin's testimony. Transactional attorneys seeking to avoid litigation should either include the intent of the transferor directly in the deed, or record it contemporaneously with the transfer in a trust agreement.

Williams v. Leaver is also a reminder of the importance of careful pleading. The court found that the resulting trust entitled Wanda and Kevin to one-half of the property. However, because Wanda and Kevin only sought two of the six acres, one-third of the total property, the court affirmed the one-third to two-thirds split of the property reached by the trial court. Courts will not grant relief which has not been sought.

CONTRACTS

Tennessee courts shall not invalidate a contract as a matter of public policy when the provisions are legally severable or when the party seeking to invalidate the contract has received the benefit of the other party's performance. *Baugh v. Novak*, 340 S.W.3d 372 (Tenn. 2011).

By Isabel T. Archuleta

In Tennessee, it is well established that individual autonomy and freedom of contract are among the greatest of personal liberties. However, courts may invalidate contracts entered between consenting parties on the grounds that they violate public policy. A voluntary agreement may be deemed invalid as a violation of public policy if the illegality is "inherent" and not simply collateral. In *Baugh v. Novak*, the Tennessee Supreme Court addressed the issue of whether a contract for the sale of an interest in a corporation and related indemnification agreements were unenforceable because they were contrary to public policy. The Supreme Court found that the purchasers of the corporate interest entered into the agreement as informed buyers with their "eyes open." In addition, the buyers received the benefit of the seller's performance for nearly a decade. And finally, neither party nor the public was harmed by a violation of public policy.

In June 1992, Wendell and Laura Baugh acquired Precision Services, Inc. from Ronald and Gayla Miller. The Millers agreed to finance the transaction, and the Baughs personally guaranteed a note executed by the corporation that purchased Precision and the right to use its name.

Herman Novak and his wife, Faith, were friends and neighbors of Mr. and Mrs. Baugh. In 1994, Messrs. Baugh and Novak bought Penske Plastics, Inc., and per their arrangement, were jointly and severally liable for the company's debts and obligations. Additionally, both agreed to share the company's profits equally.

In late 1994 or early 1995, Mr. Baugh offered to sell one-half of Precision Services to Mr. Novak. Because Mr. Baugh found the Millers difficult to deal with, he asked his attorney to structure the transaction so that Mr. Novak could purchase an interest in Precision without obtaining the Millers' permission. The final document included an indemnity clause in which the Novaks agreed to indemnify the Baughs for fifty percent of any payments they were required to make on the Millers' note and Precision's other debts. Likewise, the Baughs provided an indemnity agreement to the Novaks per their request.

In 2003 a fire destroyed the Penske Plastics building, along with the original signed copies of the Baugh-Novak 1995 purchase agreements. In 2005, Messrs. Baugh and Novak sold Penske Plastics to Alcan Baltec. Up to the time of the closing of the sale of Penske Plastics, Precision's debts and loan obligations were paid using the revenue of Penske Plastics. In December of 2005, Mr. Novak essentially "wash[ed] his hands" of the Precision obligations in a handwritten note sent to Mr. Baugh.

Mr. Baugh, having everything "dumped on his lap," began paying Precision's obligation to the Millers and its loan to First State Bank using his personal funds. On June 19, 2006, Mr. Baugh filed suit against the Novaks to enforce the terms of the 1995 indemnity agreement, arguing that he was entitled to indemnification and reimbursement for Precision's obligations to the Millers and First State Bank. The Novaks counterclaimed, arguing that the Baughs had fraudulently provoked them to purchase the interest in the corporation.

The trial court awarded $201,715.50 to the Baughs and dismissed the Novak's counterclaim. The Tennessee Court of Appeals, however, on its own motion, invalidated the purchase agreement and the related indemnification agreements because they were contrary to the public policy established in section 48-16-208 of the Tennessee Code. On appeal, the Tennessee Supreme Court noted that while courts may have the authority to nullify or invalidate contracts on the grounds of public policy, the authority requires the courts to act with "great delicacy." To simply void contracts because they contradict public policy is "in tension with the freedom of contract and the desire to hold parties to their voluntary agreements."

In determining whether a contract should be deemed unenforceable on the grounds of public policy, the court provided a three-prong test: (1) the violation of public policy must be clearly established; (2) the violation must be inherent in the contract itself or the contract's purpose must taint it with illegality; and (3) a clear public detriment must be likely to occur as a result of the contract or the object of the contract must tend to injure the public. Additionally, the court explained that in situations where the party seeking an invalidation of the contract has received the benefit of the other party's performance, courts must be even more hesitant to nullify the contract on the grounds of public policy.

The Tennessee Supreme Court, in upholding the trial court's determination that the contract did not violate public policy, held first that neither the public, the Millers, nor the Novaks were harmed by any violation of section 48-16-208. Second,

it is not clear that the stock purchase agreement made in 1995 between Messrs. Baugh and Novak violated section 48-16-208. Third, it is unclear that the Tennessee General Assembly intended to invalidate contracts like the one in question. Fourth, the overreaching remedy of invalidating the purchase and indemnity agreements is unnecessary as it would be simple to sever the indemnification arrangement from the stock purchase agreement. Finally, the court emphasized the fact that in the case at hand, the Novaks, the party wishing to invalidate the agreement, enjoyed the benefit of the Baughs performance under the contract for almost a decade. Thus, the Tennessee Supreme Court reinstated the trial court's decision and dismissed the Novaks' appeal.

The Tennessee Supreme Court's ruling in *Baugh v. Novak* serves as a reminder of the arduous battle a party faces when trying to invalidate a contract between private parties on the grounds of public policy. The decision emphasizes the importance of the individual right of freedom of contract and the limited authority the courts have in addressing voluntary private party agreements. Attorneys representing contracting parties should encourage their clients to thoroughly consider the contracts in which they enter, and remind their clients that possible violations of public policy are not an absolute "out." Instead, the contracting parties will likely be required to live by the consequences of their voluntary agreements.

INTELLECTUAL PROPERTY

The clear and convincing evidentiary standard applies to all invalidity challenges to patents, even when the patent's prior art has not been considered by the United States Patent and Trademark Office. *Microsoft Corp. v. i4i Ltd. P'ship*, 131 S. Ct. 2238 (2011).

By CeCe Ging

In a patent infringement action, an alleged infringer may assert invalidity of the patent as a defense. In *Microsoft Corp. v. i4i Ltd. P'ship*, the United States Supreme Court addressed the issue of the standard of proof in a patent invalidity defense, specifically whether § 282 of the Patent Act of 1952 requires an invalidity defense to be proven by clear and convincing evidence.

I4i Limited Partnership ("i4i") holds a patent that claims an improved method for editing computer documents. In 2007, i4i filed for a willful infringement action against Microsoft Corporation ("Microsoft"). In addition to denying infringement, Microsoft counterclaimed and sought a declaration that i4i's patent was invalid and unenforceable. Specifically, Microsoft claimed that i4i's prior sale of a software program, known as S4, more than one year prior to the filing of the i4i patent application rendered the patent invalid. The only disputed fact was whether the S4 software embodied the invention claimed in i4i's patent. Relying on the undisputed fact that the prior sale of the S4 software was never presented to the United States Patent and Trademark ("USPTO") examiner, Microsoft objected to the jury instruction that required Microsoft to prove its invalidity defense by clear and convincing evidence. The Federal District Court dismissed Microsoft's objection, and the Court of Appeals for the Federal Circuit affirmed.

According to § 282 of the Patent Act of 1952, "a patent shall be presumed valid" and "the burden of establishing invalidity . . . rests on the party asserting such invalidity." Under the Federal Circuit's reading of § 282, a defendant seeking to overcome this presumption must persuade the fact finder of its invalidity defense by clear and convincing evidence.

In a unanimous decision, the Supreme Court held § 282 requires an invalidity defense to be proven by clear and convincing evidence regardless of whether the evidence before the fact finder was examined by the USPTO during the examination process. Any recalibration of the evidentiary standard of proof in a patent infringement case remains in the hands of Congress. In reaching this decision, the

Court rejected both of Microsoft's arguments: (1) that a defendant in an infringement action need only persuade the jury of an invalidity defense by a preponderance of the evidence and (2) in the alternative, that the standard of proof should be lowered to a preponderance of the evidence when an invalidity defense involves evidence not presented to the USPTO.

In response to Microsoft's arguments, the Court emphasized statutory interpretation rather than policy considerations. The Court pointed out that where Congress uses a common law term in a statute, the Court will assume the term comes with a common law meaning, absent anything pointing another way. Here, by stating that a patent is "presumed valid" in § 282, Congress used a term with a settled meaning in the common law. The Court held thirty years before the enactment of § 282 in *Radio Corp. of America v. Radio Engineering Laboratories, Inc.*, 293 U.S. 1(1934), that a presumption cannot be overthrown except by clear and cogent evidence. By the time Congress enacted § 282 and declared that a patent is "presumed valid," the presumption of patent validity had long been a fixture of the common law. Under the general rule that a common law term retains its common law meaning, the Court concluded that Congress did not intend to "drop" the established heightened standard of proof from the presumption simply because § 282 fails to reiterate it expressly.

In addition, by rejecting a fluctuating standard of proof, the Court noted that nothing in the text of § 282 suggests that Congress meant to enact a standard of proof that would rise and fall with the facts of each case. The established case law only reflects that new evidence supporting an invalidity defense may "carry more weight" in an infringement action than evidence previously considered by the USPTO; however, the standard of proof remains the same.

Finally, the Court stated that it was in no position to judge the comparative force of the proposed policy arguments from both sides. Congress specified the applicable standard of proof in § 282 of the Patent Act in 1952. Since then, it has allowed the Federal Circuit's clear and convincing standard to remain in place. Not once has Congress, who has the power to recalibrate the standard of proof, even considered a proposal to lower the standard of proof.

The Supreme Court's decision in this case effectively reaffirmed the heightened standard of proof required for an invalidity defense in a patent infringement case. This is good news for patent holders because the Court's decision maintained the value of U.S. patents by both preserving the presumption of

patent validity and rejecting the application of a lower standard of proof for establishing patent invalidity. However, transactional attorneys should still be cautious in dealing with patents. Even though the Court has upheld the clear and convincing standard, it emphasized that "new evidence," not originally presented to the USPTO, may still carry more weight to overcome the standard of proof. Also, the Court did not dismiss the policy arguments in favor of a lower standard; it only shifted the decision-making process to Congress.

PROPERTY

Boundary line disputes involving only boundary deeds invite courts to rely heavily on the opinions of experts and surveyors, encouraging clients to rigorously search for those willing to find in their favor. *Dillehay v. Gibbs, No.* M2010-01750-COA-R3-CV, 2011 Tenn. App. LEXIS 325, 2011 WL 2448253 (Tenn. Ct. App. June 16, 2011).

By Annie Ellis

Boundary line disputes are problematic when the only relevant deeds are boundary deeds, which by definition do not give necessary calls and distances to place the exact mathematical locations of the disputed property lines. The inadequacy of the boundary deeds invites the courts to rely heavily on the opinions of experts and surveyors, encouraging parties to rigorously search for professionals to find in their favor. In *Dillehay v. Gibbs*, the Tennessee Court of Appeals established a procedure for how these types of disputes are to be handled and what types of offered opinions are to be considered.

The boundary line dispute in *Dillehay* concerned two neighboring farms in Smith County, Tennessee. Ms. Gibbs (the "Defendant") purchased her farm in 1993 by a deed conveying 159 acres. The Defendant was "returning" home as the farm had been in her family since 1920. Ms. Dillehay (the "Plaintiff") purchased her farm in 2005 by a deed conveying two tracts, which together amounted to 134 acres. The Plaintiff, and her seller, were unfamiliar with the farm and asked the Defendant where the boundary line was located during a tour of the property. Upon inspection of the premises, the parties realized that the area was littered with remnants of old fences and could see that the location of the correct fence line would be the subject of a later dispute.

The Plaintiff filed her complaint in chancery court to establish the boundary line between the two farms. A temporary restraining order was issued enjoining both parties from trespassing upon the disputed land. The Defendant answered the Plaintiff by contending that she had a valid recorded survey depicting the true property lines in her favor, and alternatively, that she was the true owner by virtue of adverse possession.

Because the parties only held boundary deeds, both parties hired licensed land surveyors to establish a definitive boundary line. Each surveyor suggested a different line established from different methods with varying degrees of certainty.

Generally, the Plaintiff's experts' lines followed a woven-wire fence and were set further east than the Defendant's expert's line, which was set to the west and followed the remnants of a barbed wire fence.

The Plaintiff's first expert, Mike Holland ("Mr. Holland"), researched land records at the courthouse, collected data in the field, and spoke with both parties. He did not perform a mathematically closed survey of the farm. At trial, he presented a line extrapolated from old deeds in the Plaintiff's chain of title, using the calls, distances, and monuments of those deeds. He offered that although these markings were not from the Plaintiff's deed itself, the old deeds reflected the boundary line as it was understood at the time of their making. However, Mr. Holland's line was problematic because he never shot the line from the ground and only drew it from a map. Further, while Mr. Holland stated that his exhibit represented the line to a reasonable degree of certainty, he refused to actually call it the "boundary line." He said he would "'not force a line.'"

Accordingly, the Plaintiff hired a second expert, Richard Puckett ("Mr. Puckett"). Mr. Puckett's line generally followed Mr. Holland's line. However, unlike Mr. Holland, Mr. Puckett shot his line from the ground, and consequently, his line was more contoured to the shape of the land. Still, Mr. Puckett testified that because the two properties only had boundary deeds, mathematical closure of the boundaries was not possible and that he did not actually know where the boundary line was.

The Defendant's expert, Carroll Carman ("Mr. Carman"), testified to a line located much further west of Mr. Holland's and Mr. Puckett's. He offered that his line was accurate to a reasonable degree of certainty and discussed his methodology in greater detail than the Plaintiff's experts. He had researched deeds, interviewed adjoining landowners, and attempted to plot the line from the ground. After finding the woven-wire fence that the Plaintiff's experts' lines followed, the Defendant's siblings told him that the boundary line was past that point. He found many fence remnants and surmised that they were once used for the containment of farm animals rather than boundary markers because of their arbitrary locations. After using a metal detector, he found the remnants of a barbed-wire fence on a very steep incline. Mr. Carman stated that, in his expert opinion, a containment fence would not be placed in such difficult terrain and that the amount of effort that would be required to place the fence there would have been intended to mark between the two farms. Mr. Carman reasoned that this was the best conclusion available to a land surveyor. Although he could not promise the line was of absolute certainty, he could

contend it was of reasonable certainty. He further admitted that he did not use the Plaintiff's deeds in her chain of title because they were not presented to him until two years after he completed his survey.

Both parties also presented lay testimony to establish the boundary line. The Plaintiff called a former owner in her chain of title who testified that he grew tobacco and raised cattle on the properties. The owner said he and his family used a barbed-wire fence to contain the animals. However, he was unclear as to where the exact boundary line was, but did say that it was to the east of Mr. Carman's.

The Defendant called four of her siblings, each of whom lived on the farm in their youth and testified regarding the boundary line as it was understood at that time. Each of the siblings testified that the barbed-wire fence was meant to mark the boundary line and all other fences were meant to contain hogs and other farm animals.

The trial court found: (1) that Mr. Carman's survey established the boundary line between the two farms; (2) that the Defendant had adversely possessed the disputed area; and (3) that the Plaintiff's predecessors in title had acquiesced in the boundary line as set by the barbed-wire fence.

On appeal, the Tennessee Court of Appeals affirmed the trial court's holdings. The Plaintiff argued that the trial court erred by relying on the survey of the Defendant's expert, and not on the Plaintiff's experts. The appellate court reviewed the trial court's decision *de novo* with a presumption of correctness as to the trial court's findings of fact.

Tennessee courts previously established that when a boundary line is in dispute, the court is to first look at the natural objects or landmarks on the property, then to the artificial objects or landmarks, followed by the boundary lines of adjacent pieces of property, and finally to courses and distances contained in documents relevant to the disputed property.

Tennessee courts have also concluded that for the evidence to preponderate against a trial court's finding of fact, it must support another finding of fact with greater convincing effect. The Tennessee Court of Appeals could not do so in this case and affirmed judgment for the Defendant. The court reasoned that the case essentially boiled down to a decision between two flawed surveys that the trial court most credited—Mr. Holland's, cobbled together from ancient deeds with little apparent connection to the land and a disclaimer to its veracity, or Mr. Carman's,

shot from the ground on an old fence with slight support from the old deeds. However, the court did find it persuasive that only Mr. Carman established a line within a reasonable degree of surveying certainty. Only he provided detailed reasons supporting his decision and extensive critiques of the other experts' methods. Further, the testimony of the Defendant's siblings corroborated his conclusion. The appellate court admitted that neither party's evidence was overwhelmingly compelling, but it gave great deference to the trial court's findings regarding the competing surveys. Therefore, it affirmed the trial court's decision.

Dillehay v. Gibbs encourages Tennessee transactional attorneys dealing with boundary deeds in a boundary line dispute to search diligently for experts and surveyors who will rigorously search any available methods to find in their client's favor. The lack of precision that boundary deeds provide invites these types of methods and opinions and assigns greater weight to them than would exist in a boundary dispute involving deeds with mathematical precision. It is also of crucial importance that any testifying expert both call his conclusion "the boundary line," which was Mr. Holland's mistake, and testify to a "reasonable degree of surveying certainty," which was Mr. Puckett's mistake. Further, attorneys should realize there is little hope for relief on appeal because of the great deference to a trial court's decision in these matters.

Under Tennessee law, courts must analyze conflicting deed provisions on a case-by-case basis, heeding the grantor's intent as shown in the specific language and circumstances of that particular deed. *Rhoden v. Rhoden*, No. W2010-00263-COA-R3-CV, 2011 Tenn. App. LEXIS 532, 2011 WL 4489985 (Tenn. Ct. App. Sept. 29, 2011).

By Keshia L. Williams

In Tennessee, the interpretation of a deed is a question of law for the court's determination. In interpreting a grantor's intent in a deed of property, Tennessee courts consider the document's language and surrounding circumstances, taking into account a presumption favoring enforcement of every deed provision. In *Rhoden v. Rhoden*, the Tennessee Court of Appeals addressed whether a tenancy in common created by deed may include a right of survivorship in light of the deed's language. Following precedent, the court held that the express language of the deed controls

the establishment of a right of survivorship regardless of the property interest conveyed.

In a sale on August 31, 1992, Eleanor H. Reed ("Reed") transferred twenty-six acres of land by deed to Clarence Rhoden ("Father") and his son Richard Rhoden ("Richard"). The deed identified both Father and Richard "as tenants in common with a right of survivorship" but also conveyed the property to Father, Richard, "and their heirs." Father, Richard, and a second son Donald Rhoden ("Donald") lived on the property together. After Father's death, however, Richard asked Donald to vacate the property, and Donald refused to leave. On April 12, 2010, Richard filed an unlawful detainer action against Donald, claiming that Donald had no legal right to hold over possession of the property after Father's death and Richard's request.

On December 28, 2010, after a bench trial, the Circuit Court of Chester County entered an order in favor of Richard. The trial court relied heavily on the deed's language, which specifically mentioned creating a right of survivorship in the surviving tenant. On appeal, the Tennessee Court of Appeals affirmed the circuit court's opinion on the validity of the right of survivorship in the tenancy in common at issue. Because a deed is interpreted primarily to determine the grantor's intent, the court of appeals held that the specific language of survivorship in the deed outweighed any possible ambiguities in other generic provisions of the deed, such as the type of interest conveyed and the declaration of clear title.

Under Tennessee law, the language within and the circumstances surrounding a deed govern the court's consideration of the grantor's intent in transferring the property at issue. In completing this determination, courts presume that the parties intended for every provision of the deed to hold some validity. Therefore, a court will interpret a deed in the manner likely to give effect to the most provisions possible.

A tenancy in common neither automatically creates a right of survivorship nor absolutely prohibits such a right. In *Runions v. Runions*, 207 S.W.2d 1016 (Tenn. 1948), the Tennessee Supreme Court established the validity of combining a right of survivorship with a tenancy in common created by deed. The court in *Runions* held that, in light of the grantor's intent, the right of survivorship and the tenancy in common are both valid when explicit language in the deed created the survivorship right. The type of estate given does not control a survivorship right for which the deed explicitly provides.

On appeal, the Tennessee Court of Appeals held that a right of survivorship was valid within a tenancy in common when the deed's language conveyed that the grantor's intent was to create such a right within that estate. The court found a right of survivorship in Richard, which entitled him to sole ownership and possession of the property.

The key to determining the validity of the right of survivorship lies within the deed's language and the grantor's intent regardless of the type of estate created. Donald first argued that as a matter of Tennessee law, a right of survivorship could not exist within a tenancy in common irrespective of the deed's reference to such a right. Essentially, he argued that the legal definition of a tenancy in common did not allow for a survivorship right. Here, the court confirmed that a tenancy in common does not create a right of survivorship without some express indication of the right. However, the court strictly followed the approach in *Runions*, relying on the deed's language as evidence of the grantor's express intention to create a right of survivorship even when conveying an estate in common.

Further, in considering the face of the deed, generic provisions, such as technical descriptions and declarations of clear title, are insignificant in comparison to explicit language creating a right of survivorship. As an alternate argument, Donald insisted that the conveyance of property to Father, Richard, "and their heirs" was inconsistent with a right of survivorship in the surviving tenant in common. However, the court found no relevance in the phrase "and their heirs" and ruled that its use merely established that Reed conveyed good, clear title to Father and Richard through the deed. Though there was no transcript or statement of evidence from the circuit court's bench trial on which to factually base this assumption, the court of appeals consciously chose to focus on the direct language of survivorship in spite of a possible inconsistency in a more general deed provision.

Rhoden v. Rhoden provides distinct support for interpreting a deed by its most direct language. The court's decision to uphold a right of survivorship within a tenancy in common based on a deed's language serves as a reminder for both attorneys who draft deeds for clients and attorneys whose clients enter deeds that others drafted. For clients transferring property by deed, the creation of a right of survivorship for a tenancy in common hinges on the explicit language of the deed. Therefore, in conveying property, the drafter must be careful to either explicitly include or exclude the mention of a survivorship right in the surviving tenant. On the other hand, attorneys reviewing deeds for clients who will receive the property

must be careful to ask clients whether they desire a right of survivorship and then to determine whether the deed's express language provides such a right.

Though the Tennessee Court of Appeals followed the Tennessee Supreme Court's principle in *Runions*, the designation of *Rhoden v. Rhoden* as a memorandum opinion shows the court's hesitance to create precedent in its holding. While *Runions* established the validity of a right of survivorship within a tenancy in common, its holding broadly focused on the grantor's intent, leaving the door open for interpretations as to what language, in light of some ambiguities, concretely establishes that intent. *Rhoden v. Rhoden* exemplifies how Tennessee courts must employ a case-by-case analysis of possibly conflicting deed provisions to determine the grantor's intent.

SHAREHOLDER LITIGATION

Under Delaware Law, a *Brophy* claim no longer requires an element of harm to the corporation for disgorgement to be an available remedy. *Kahn v. Kolberg Kravis Roberts & Co., L.P.,* 23 A.3d 831 (Del. 2010).

By Nathaniel Dallas

In *Brophy v. Cities Serv. Co.,* 70 A.2d 5 (Del. Ch. 1949), the Delaware Court of Chancery held that a plaintiff may bring a claim for breach of fiduciary duty even if there is no harm to the corporation. Later, in *Pfeiffer v. Toll,* 989 A.2d 683 (Del. Ch. 2010), the Delaware Court of Chancery concluded that the purpose of a *Brophy* claim is to remedy harm to a corporation. As such, the Court of Chancery stated that in most cases a corporation would only be allowed to recover for actual harm. However, the court did state two circumstances where disgorgement would be "theoretically available": (1) where the fiduciary engages in actual fraud and (2) where confidential information is used to compete directly with the corporation. In *Kahn v. Kolberg*, the Delaware Supreme Court addressed whether a *Brophy* claim, under any circumstances, requires an element of harm before disgorgement is an available remedy.

In *Kahn v. Kolberg*, Alan Spiegal and Linda Parnes Kahn (collectively "Kahn") brought suit against Kohlberg, Kravis, Roberts & Co., L.P. ("KKR"), Primedia, Inc. ("Primedia"), and eleven current and former directors of Primedia. Spiegal and Kahn were minority shareholders of Primedia. KKR was a majority shareholder with three of its designees on Primedia's board of directors (the "KKR directors"). In late 2001 and mid-2002, Primedia's board of directors approved two separate plans, each authorizing Primedia to acquire up to $100 million of its preferred shares. Five days after the second $100 million was authorized, the KKR directors sent an advisory memorandum to KKR that contained nonpublic information about Primedia and advocated the purchase of Primedia's preferred shares.

At some point during 2002, KKR sought permission from Primedia's board of directors to purchase Primedia's preferred shares. The unanimous written consent stated, in part, that KKR's purchase of $50 million shares was acceptable and not a usurpation of corporate opportunity. Primedia's board of directors purportedly executed the written consent on July 8, 2002, although the record was unclear as to when the written consent became effective. Nonetheless, on July 3, 2002, KKR formed ABRA III, L.L.C. ("ABRA") as an investment vehicle to

purchase Primedia's preferred stock, and between July 8, 2002 and November 5, 2002, purchased $75 million of Primedia's preferred stock.

Following these events and Primedia's redemption of some of its preferred stock, Kahn filed a derivative action against KKR, Primedia, and eleven Primedia directors. Later, Kahn filed the First Amended Complaint alleging that the redemptions of Primedia's preferred stock were unfair to Primedia and benefited KKR at a cost to Primedia. After its first motion to dismiss was denied, Primedia formed a Special Litigation Committee (the "SLC") to investigate the claim. The SLC moved to stay the action pending its investigation and the court granted the stay. During the investigation, Kahn filed the Second Amended Complaint. However, it was not until after reviewing the SLC's report that Kahn filed the Third Amended Complaint which included the *Brophy* claim that KKR breached its fiduciary duty by purchasing the preferred stock at a time when they possessed material, nonpublic information.

At trial, the court of chancery granted the SLC's motion to dismiss. The vice chancellor applied the two-part standard articulated in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) to the SLC's motion to dismiss. Part one of the *Zapata* standard analyzes the independence and good faith of the committee members, the quality of its investigation, and the reasonableness of its conclusion. Part two of the *Zapata* standard may be utilized at the discretion of the court and seeks to strike a balance between a legitimate corporate claim and the corporation's best interest. The vice chancellor found that the SLC met its burden under part one of the *Zapata* standard and upheld the SLC's motion to dismiss under part two.

On appeal, the Delaware Supreme Court held that a *Brophy* claim does not require an element of harm before disgorgement is an available remedy. Prior to addressing the availability of the disgorgement remedy in a *Brophy* claim, the court first invoked the exception to the mootness doctrine. During the pendency of the appeal, Primedia entered into an acquisition agreement with TPG Capital. In the transaction, Kahn's stock would be purchased for cash. Thus, at the closing of the transaction Kahn would lose standing to pursue the case and the issue would be moot. While the court normally declines to decide moot issues, the court invoked the exception to mootness doctrine because the *Brophy* issue had been raised in other actions pending before the court of chancery.

Having invoked the exception to mootness doctrine, the court went on to resolve the legal issue concerning the availability of the disgorgement remedy for a

Brophy claim. The court, exercising *de novo* review, held that a *Brophy* claim does not require an element of harm before disgorgement is an available remedy. First, the court looked to the venerable case *Brophy v. Cities Service Co.*, 31 Del. Ch. 241 (Del. Ch. 1949), where the court of chancery expressly rejected the argument that the plaintiffs failed to state a claim because there was no harm to the corporation. Accordingly, the court found that when a fiduciary profits from confidential corporate information, equity requires disgorgement of those profits even if the corporation did not suffer actual harm. Further, the court reaffirmed the elements necessary for a plaintiff to prevail on a *Brophy* claim. Specifically, that the corporate fiduciary possessed material nonpublic information and used that information improperly by making trades motivated by that information. Finally, the court held that *Pfeiffer* was no longer good law to the extent it conflicted with its interpretation of *Brophy*. The court, relying on *Guth v. Loft, Inc.,* 5 A.2d 503 (Del. 1939), specifically rejected *Pfeiffer's* narrow interpretation of the availability of disgorgement in a *Brophy* claim.

After establishing that a *Brophy* claim does not require an element of harm for disgorgement to be an available remedy, the court reviewed the trial court's analysis under the two-part *Zapata* standard. The court, exercising *de novo* review, agreed with the vice chancellor's determination that the SLC had met its burden under part one of the *Zapata* standard. The court cited the length and thoroughness of the SLC investigation report and agreed that the SLC acted in good faith and had a reasonable basis for its conclusions.

However, under part two of the *Zapata* standard, the court, reviewing for abuse of discretion, was unable to determine whether the vice chancellor had upheld the SLC's motion to dismiss by improperly relying on *Pfeiffer*. Even though the SLC did not rely of *Pfeiffer* in its motion to dismiss, it did argue lack of harm during oral argument. Further, the vice chancellor did not discuss the elements he relied on in granting the SLC's motion to dismiss. Accordingly, the court could not determine whether the vice chancellor had improperly relied on *Pfeiffer* and the lack of harm to the corporation in his decision to dismiss the claim. As such, the Delaware Supreme Court reversed the decision of the court of chancery and remanded the case for proceedings consistent with its interpretation of *Brophy*.

In light of this decision, transactional attorneys should be aware that harm to the corporation is no longer required for disgorgement to be an available remedy for a *Brophy* claim. This makes it easier for a plaintiff's attorney to bring an action where a fiduciary has been unjustly enriched through the use of material nonpublic

corporate information but the corporation has not suffered any harm. Also, corporate attorneys, when faced with a *Brophy* claim, must refrain from arguing lack of harm as a defense to a *Brophy* claim. While a judge will readily disregard this argument, it may leave the door open for an appeal if the judge does not specifically state what elements were relied on in granting a motion to dismiss. As shown in *Kahn v. Kolberg*, a case will be appealable if lack of harm is argued and one cannot determine whether the trial judge relied on lack of harm to the corporation in upholding the motion to dismiss.

Appraisal rights might not be triggered in connection with a merger of a public target corporation so long as the shareholders are not required to receive cash and can, instead, elect to receive publicly listed securities. *Krieger v. Wesco Financial Corp.,* 30 A.3d 54 (Del. Ch. 2011).

By N. Adam Dietrich II

Appraisal rights are the rights of shareholders to demand the payment of a fair price for their shares during a merger or other extraordinary corporate event. In this sense, appraisal rights ensure that minority shareholders receive the benefit of their bargain by preventing corporations involved in mergers from paying less than what the company is worth. For Delaware corporations, appraisal rights are available under section 262(b) of the Delaware General Corporation Law ("DGCL"). In *Krieger v. Wesco Financial Corp.*, Joel Krieger ("Plaintiff"), a minority owner of ten shares of Wesco Financial Corporation ("Wesco") stock, brought suit to enjoin a forward triangular merger between Wesco, its parent Berkshire Hathaway Inc. ("Berkshire"), and Montana Acquisitions, LLC on the grounds that the common shareholders were entitled to appraisal rights and that the disclosures regarding the appraisal rights were false and misleading. At issue in this case was whether the "market out" exception to the general appraisal right authorized Wesco's denial of such rights or whether the "exception to the exception" contained in section 262(b)(2) of the DGCL applied. Ultimately, the court granted the defendants' request for partial summary judgment, holding that the minority shareholders were not entitled to appraisal rights because they were not required to accept a form of merger consideration triggering appraisal rights under section 262(b)(2) of the DGCL.

Wesco is a Delaware corporation engaged in the insurance, furniture rental, and steel service center businesses. On February 4, 2011, Wesco and Berkshire, owner of 80.1% of Wesco's outstanding common stock, entered into a merger agreement in which Wesco would merge into Montana Acquisitions, LLC—a wholly-owned subsidiary of Berkshire formed solely to consummate the merger. Pursuant to the agreement, Wesco's minority shareholders were issued an election form in which they could decide to either (1) convert their shares into the right to receive $385 per share in cash, (2) receive an equivalent value in publically traded shares of Berkshire Class B common stock, or (3) receive a combination of cash and Berkshire common stock. Those shareholders that did not make an election would receive cash.

The shareholders were also issued a proxy statement in connection with the merger disclosing Wesco and Berkshire's belief that, pursuant to Delaware law, dissenting shareholders would not be entitled to appraisal rights because they were not *required* to accept cash for their shares; rather, they had the option to elect any of the three forms of consideration. The election form was due two business days prior to the special meeting held to consider the merger, while the proxy was due at any time before the actual vote. The merger was approved at the special meeting, and no Wesco shareholder demanded appraisal.

Plaintiff filed suit the day after the merger announcement and sought a preliminary injunction, arguing that the shareholders were entitled to appraisal rights and that statements regarding such rights in the proxy statement were false and misleading. The injunction was denied, and, thereafter, the parties cross-moved for partial summary judgment on the issue of appraisal rights. The Delaware Court of Chancery granted the defendants' request for partial summary judgment and held that the Wesco shareholders were not entitled to appraisal rights because they were not required to accept a form of merger consideration triggering appraisal rights under section 262(b)(2) of the DGCL.

The court began its review of the applicable statutory authority by noting that, as a general matter, Wesco shareholders would be entitled to appraisal rights under section 262(b) of the DGCL. However, the court explained that section 262(b)(1) creates the "market-out" exception, which states that "'no appraisal rights . . . shall be available for the shares of any class or series of stock, which stock . . . [was] either (i) listed on a national securities exchange or (ii) held of record by more than 2,000 holders.'" Because Wesco's common stock was listed on a national securities exchange before the merger, appraisal rights would not be available under

the market-out exception. With that said, the court noted a further section—known as the "exception to the exception"—which "restores appraisal rights to a class or series of stock otherwise covered by the market-out exception if the holders are required to accept certain types of consideration [in the merger]." Under section 262(b)(2), the appraisal-triggering consideration *does not* include, among other categories, shares of stock listed on a national securities exchange, cash in lieu of fractional shares, and any combination of shares of stock and cash in lieu of fractional shares. Therefore, Plaintiff argued that Wesco shareholders who declined to make an election were required to accept cash as consideration for their shares; thus, the "exception to the exception" applied, and they were entitled to appraisal rights.

The court rejected Plaintiff's argument by first noting that Plaintiff's focus on the *individual* shareholders who failed to make an election was misguided. Rather, the court explained that "[t]he General Corporation Law in fact makes appraisal rights available on a transactional and class-wide (or series-wide) basis. Stockholders can choose individually whether to perfect and pursue their appraisal rights, but the underlying statutory availability of appraisal rights is not a function of individual choice." Furthermore, the court noted that even if you focus on the individual shareholders, it would be incorrect to say that they were "required" to accept cash. These shareholders had a choice to either make an election and select a form of consideration desirable to them, or they could not make an election and receive the default cash consideration. To make this point, the court quoted Jean-Paul Sartre, who said: "'[W]hat is impossible is not to choose. I can always choose, but I must also realize that, if I decide not to choose, that still constitutes a choice.'"

Next, the court addressed the Plaintiff's argument that those shareholders who wanted to vote against the merger had no choice but to receive the default cash consideration because the election deadline preceded the vote. The court quickly dismissed this argument, however, because "[t]he merger agreement did not condition the right to elect a particular form of consideration on voting for or against the merger." Similarly, the court rejected Plaintiff's argument that Wesco's shareholders were coerced into not making an election due to a misleading disclosure relating to their ability to perfect and pursue an appraisal proceeding. The court reasoned that this type of disclosure, while misleading, could only warrant "a quasi-appraisal remedy" in some circumstances but not in cases where appraisal rights were properly denied. Finally, the court was not persuaded by Plaintiff's final argument that the proxy statement equivocated over the availability of appraisal rights. Rather,

the court found that these disclosures were accurate and complete and that "[t]he defendants had a strong statutory basis for concluding that appraisal rights were not available."

Krieger v. Wesco Financial Corp. is yet another example of the difficulty that shareholders face when challenging unfavorable corporate decisions in Delaware. Particularly, this almost insurmountable hurdle becomes increasingly more difficult when, as here, it appears that the board of directors made an informed decision, in good faith, and with the best interests of the corporation in mind. In practice, the court's decision in *Wesco* provides guidance for interpreting section 262(b) of the DGCL and clarifies an unsettled area of law in regards to the availability of appraisal rights. Transactional attorneys in merger negotiations can now feel comfortable advising their public corporation clients that they can deny appraisal rights so long as the shareholders are not required to receive cash and can, instead, opt to receive publicly listed securities. Furthermore, *Wesco* suggests that a proxy statement disclosure is an appropriate means to notify the shareholders of the availability of appraisal rights. Finally, corporate litigators representing complaining shareholders should be mindful that the availability of appraisal rights is determined on a class-wide, rather than individual, basis. For example, just because an individual shareholder declined to make an election and was required to accept cash does not mean that the shareholder is entitled to appraisal rights.

An equity dilution plaintiff may initiate both derivative and direct claims without showing an equivalent correlation between their decrease in equity and the increase in controlling shareholders' ownership. *Dubroff v. Wren Holdings, LLC*, C.A. No. 3940-VCN, 2011 Del. Ch. LEXIS 164, 2011 WL 5222866 (Del. Ch. Oct. 28, 2011).

By Devin Lyon

In *Dubroff v. Wren Holdings, LLC* the Delaware Court of Chancery refined, *inter alia*, the issue of whether minority shareholders' equity must decrease at the exact amount of the increase in the controlling shareholders' equity when pursuing a claim for equity dilution. The case arose during the fallout from the 2008 financial crisis in a time of extreme economic uncertainty and a public decline in deference toward corporate directors. *Dubroff* reexamined and lessened Delaware's exacting

standard regarding equity dilution by amplifying the holding from *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006).

Dubroff involved two sets of plaintiffs—the Dubroff Plaintiffs and the Fuchs Plaintiffs—who were minority shareholders in Nine Systems Corporation ("NSC"). Both sets of Plaintiffs filed lawsuits against NSC's control group and four of NSC's controlling shareholders for, *inter alia*, breach of fiduciary duties and unjust enrichment. The complaints stemmed from the controlling shareholders' recapitalization plan (the "Recapitalization"), which involved a reverse stock split, a stock reclassification that gave some Fuchs Plaintiffs preferred stock, and amendments to the certificate of incorporation. Fourteen minority shareholders signed a new shareholders' agreement, detailing how each signatory understood the agreement and had the opportunity to consult counsel. Shortly after implementation of the Recapitalization, the controlling shareholders sent an update notice to all shareholders that explained the reverse stock split. The update notice did not, however, explain who benefited from the Recapitalization.

Ultimately, the Recapitalization resulted in the ballooning of the controlling shareholders' ownership in NSC's equity value from approximately 56% to 90%. Minority shareholders first became aware that their equity had been reduced to less than 6% four years after the Recapitalization when NSC sent proxy materials to all shareholders to receive approval for NSC's acquisition by another company. After the Dubroff Plaintiffs failed in their attempt to gain class certification (in the sister case of *Dubroff I*), the Fuchs Plaintiffs (hereafter referred to as "Plaintiffs") filed motions to intervene and consolidate the two *Dubroff* cases.

Delaware law was in flux at the time of this opinion. Equity dilution law had historically required plaintiffs to plead a derivative claim to proceed. A derivative claim, in turn, required plaintiffs to have continuous ownership in the company to establish a cause of action (meaning former shareholders could not bring an equity dilution claim because they no longer had ownership in the company). However, under *Gentile*, the Delaware Supreme Court held that some equity dilution claims could be pled derivatively and directly, which would permit former shareholders to bring equity dilution claims. These dual claims arise when (1) a majority or controlling shareholder "causes the corporation to issue 'excessive' shares of its stock [for the controlling shareholder's assets] of a lesser value," and (2) the controlling shareholder's ownership increases while the minority shareholders suffer a corresponding decrease in ownership.

Delaware equity dilution law also historically required plaintiffs to show an equivalent correlation between their decrease in equity and the controlling shareholders' increase in ownership. Therefore, Defendants argued that the ability to bring dual pleadings under *Gentile* only applied in cases where such an equivalent correlation could be shown. In other words, if the Plaintiffs could not show harm to their equity that exactly matched the gain for controlling shareholders, Defendants argued that they were not entitled to exploit the *Gentile* holding.

The Delaware Court of Chancery held that the Plaintiffs could proceed with a direct equity dilution claim because their complaint contained sufficient factual evidence to allow a reasonable inference of individual injury. The court of chancery began by creating a three-part test for determining whether Plaintiffs could pursue a direct equity dilution claim against the controlling shareholders. The direct claim could continue if Plaintiffs pled facts alleging that the Defendants: (1) were controlling shareholders, (2) were responsible for issuing "excessive" shares to the controlling shareholders, and (3) through the share issuance, increased their ownership while decreasing minority shareholders' ownership.

After finding that the Plaintiffs had sufficiently pled facts supporting the first two prongs, the court moved on to the third prong, where it stated the noteworthy aspects of its opinion. The Defendants argued that there could be no claim for equity dilution because some of the Plaintiffs received preferred stock—seemingly upgrading their previously held common stock. However, the court chided such simplistic interpretations of direct equity dilution claims that require equivalent correlations between controlling shareholder increase and minority shareholder decrease. The court inferred that, logically, minority shareholders could enjoy an increase in ownership and still have a direct claim for equity dilution. Or, as the Delaware Supreme Court upheld in *Gatz v. Ponsoldt*, 925 A.2d 1265 (Del. 2007), direct equity dilution exists when controlling shareholders receive no benefit but minority shareholders lose ownership. Thus, the court of chancery substantially broadened the direct equity dilution claim. As the court stated, the Plaintiffs alleged that the "primary effect" of the Recapitalization was "an extraction from [NSC's] public shareholders and a redistribution to [NSC's Control Group], of a [substantial] portion of the economic value and voting power embodied in the minority interest."

One obstacle for the court's opinion was that minority shareholders provided written consent for the Recapitalization before it went into effect by signing either the amended shareholder agreement or the proxy materials before acquisition. The court cited this case's sister opinion in *Dubroff I*, and noted that while the controlling

shareholder disclosure requirements under section 228(e) are unsettled law, the complaint is well-pled and withstands scrutiny, regardless. If the statute requires full disclosure, the complaint supports the inference that the Defendants misled Plaintiffs. On the other hand, if the statute does not require full disclosure, the complaint supports the inference that the Defendants intentionally omitted material information to mislead the Plaintiffs. Furthermore, the court stated that the Plaintiffs were harmed by the Defendants' insufficient disclosure because they were unable to bring any legal action against the Recapitalization due to lack of information. Therefore, the court allowed the Plaintiffs' claims to proceed.

The court's final act of significance stemmed directly from its aforementioned analysis of the Defendants' disclosure. The court extended its holding that the Defendants inadequately disclosed information to skirt the three-year statute of limitations. The court stated that, due to the inadequate disclosure in the shareholders' agreement, Plaintiffs did not receive inquiry notice of the transaction until receiving the proxy materials just before the company's acquisition. Furthermore, the court held that the pending *Dubroff I* class action case tolled the statute of limitations. The court reasoned that creating a rule that tolls the statute of limitations during pending class action certification suits is necessary to avoid forcing all class members to intervene in the certification suit to preserve their claims.

The *Dubroff* case displays the judiciary's renewed focus on the boardroom, and its willingness to vigorously pursue corporate executives. While the specific holdings of this case are not binding authority on Tennessee courts, all transactional attorneys should be cognizant of the corporate climate captured within this case. Delaware is reputable in the business world due to traditionally favorable corporate laws. Thus, if the business stronghold of Delaware displays this degree of willingness to crack down on business practices by allowing derivative claims to be plead directly, discounting written agreements, and subverting the statute of limitations, corporations everywhere should be wary.

Transactional attorneys should recognize the judiciary's willingness to punish questionable corporate behavior and embrace defensive and conservative postures. Attorneys should advise business clients to forego legally questionable tactics to avoid litigation. The financial crisis has already claimed many victims, but litigious attorneys may soon discover that their clients are next.