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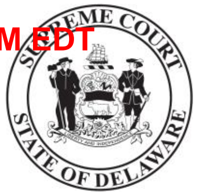

IN THE SUPREME COURT OF THE STATE OF DELAWARE

CHARLES ALMOND AS TRUSTEE FOR THE ALMOND FAMILY 2001 TRUST, ALMOND INVESTMENT FUND LLC and CHARLES ALMOND	)	
Plaintiffs Below, Appellants,	)	
v.	)	No. 215, 2019
GLENHILL ADVISORS, LLC, GLENHILL CAPITAL LP, GLENHILL CAPITAL MANAGEMENT LLC, GLENHILL CONCENTRATED LONG MASTER FUND LLC, GLENHILL SPECIAL OPPORTUNITIES MASTER FUND LLC, JOHN EDELMAN, GLENN KREVLIN, JOHN MCPHEE, WILLIAM SWEEDLER, WINDSONG DB DWR II, LLC, WINDSONG DWR, LLC, WINDSONG BRANDS, LLC, HERMAN MILLER, INC. and HM CATALYST, INC.	)	Court below: Court of Chancery of the State of Delaware, C.A. No. 10477-CB
Defendants Below, Appellees,	)	
and	)	
DESIGN WITHIN REACH, INC.	)	
Intervenor and Counterclaim-Petitioner Below, Appellee	)	

THE ALMOND APPELLANTS' OPENING BRIEF

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PRELIMINARY STATEMENT

In the trial court the parties litigated a number of issues, but this appeal is about one thing: the standing of the minority shareholders of Design Within Reach, Inc. ("DWR" or the "Company") to bring claims challenging transactions that the Court below found, after trial, were the product of a conflicted and deficient process. The Court below found that plaintiffs lacked standing because their claims for corporate overpayment, which would have been subject to the entire fairness test, were not direct claims under *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006) and therefore were extinguished by DWR's merger.

The Court of Chancery's *Gentile* analysis, however, was fatally flawed. First, the Court of Chancery incorrectly articulated the showing required to assert a direct claim under Gentile when there is a pre-existing controlling stockholder. *Gentile* requires only that the plaintiff to show that the controller expropriated voting power and economic value from the minority and either retained that benefit or converted the benefit into cash or equivalent value. It does not require that a stockholder prove the existence of a control group involving the preexisting controlling stockholder.

Second, this incorrect articulation of the showing required led to the Court improperly focusing on the dilution of the controller's interest as a result of the challenged transactions. The key question is not whether the controller, Glenhill,

was diluted but rather whether Glenhill received a benefit by permitting the other defendants to participate in the expropriation of voting power and economic value. Focusing on the dilution to the controller would lead to an unworkable analysis, weighing dilution of the controller against tangible and intangible benefits the controller may have received as a result of sharing the benefits of its expropriation.

Finally, the Court below committed legal and factual error trying to justify the outcome of its analysis. It is undisputed that these plaintiffs did not know of a majority of the transactions they now challenge until after the merger that purportedly deprived them of standing. And the disclosure of the one transaction they may have known about was inadequate to put the stockholders on notice of a potential claim. Thus, contrary to the Court's conclusion, these plaintiffs did not have the knowledge necessary to challenge these transactions in real time and did not knowingly choose to file them after the closing of the merger, aware of the risk of doing so.

On top of these errors, the rulings of the Court below set up a virtual road map for ill-intentioned actors to fleece minority stockholders of their economic value and voting power. Simply take control of a company, take it "dark" so the company has no disclosure requirements, then engage in any number of transactions expropriating value and voting power from the minority. When the expropriation is complete, enter into a merger to extinguish the stockholders'

claims. The courts of the State of Delaware cannot condone such an inequitable method of harming innocent public stockholders.

NATURE AND STAGE OF PROCEEDINGS

Plaintiffs Below-Appellants Charles Almond, individually and as Trustee of The Almond Family 2001 Trust and Almond Investment Fund, LLC (the "Almond Appellants") and Andrew Franklin (collectively, "Plaintiffs") commenced this action on December 19, 2014, by filing a Verified Complaint for Breach of Fiduciary Duties against, among others, John Edelman, Glenn Krevlin, John McPhee and William Sweedler (the "Individual Defendants"), the directors of Design Within Reach, Inc. ("DWR" or the "Company") beginning in 2010 through DWR's merger with an affiliate of Herman Miller, Inc. ("HMI") on July 28, 2014 (the "Merger"). Plaintiffs amended their complaint several times, eventually adding HMI and its affiliate as parties. DWR then intervened to seek relief under Section 205. On November 13-15, 17 and 20, 2017, the parties tried the claims in Plaintiffs' Fourth Amended Complaint and the counterclaim of DWR.

On August 17, 2018, the Court issued a Memorandum Opinion (the "Opinion" or "Op.") entering judgment in defendants' favor and against Plaintiffs on all claims in the Fourth Amended Complaint and DWR's counterclaim.

Plaintiffs sought an award of attorneys' fees based on the causal connection between the claims made in the action and the relief DWR sought in its counterclaim. On April 10, 2019, the Court issued a Memorandum Opinion denying Plaintiffs' motion for an award of attorneys' fees. On April 18, 2019, the

Court entered an Amended Final Order and Judgment. The Almond Appellants filed their Notice of Appeal on May 17, 2019. This is the Almond Appellants' Opening Brief.

SUMMARY OF ARGUMENT

1. The Court of Chancery incorrectly applied *Gentile v. Rosette*, 906 A.2d 91 (Del. 2006) in concluding that the Almond Appellants lacked standing because of the Merger to bring their breach of fiduciary duty claims against the Individual Defendants.

a. First, the Court of Chancery incorrectly held that when there is a pre-existing controlling stockholder, to make a direct claim under *Gentile* a plaintiff must prove that the controller agreed to limit or share power to prove a control group existed. That requirement makes no sense. The controller gets nothing out of a voting agreement, nor would there be any reason for Glenhill, the controller, to share that power. Here, Glenhill alone controlled a majority of the outstanding voting power. Glenhill's decision to allow the other directors of DWR – all of whom served on the DWR board at the pleasure of Glenhill, controlled by Glenn Krevlin – to participate in the spoils of plainly self-dealing transactions should be sufficient on its own to satisfy the any "controlling stockholder" requirement in *Gentile*.

b. Second, the Court of Chancery incorrectly focused on the effect of the challenged transactions on Glenhill alone when determining whether the challenged transactions resulted in an improper transfer of economic and voting power from the minority stockholders of DWR. If Krevlin as

majority stockholder had been the sole investor in the challenged transactions, there would be no question that a controlling stockholder expropriated economic and voting control from the minority resulting in a direct claim. Even if after consummation of such a transaction Glenhill transferred the ill-gotten securities to his fellow directors to achieve the same economic results as in the challenged transactions, the same result should obtain. Allowing his fellow directors to participate directly in the spoils of his expropriation should not result in a different outcome in a *Gentile* analysis. Where, as here, nothing would happen without the controlling stockholder's approval, allowing the controlling stockholder to avoid direct liability by manipulating the form of transaction leads to an inequitable result.

c. Third, the Court of Chancery erred in concluding that Plaintiffs "did not assert any of the Overpayment Claims in real time but chose to file them after the Merger closed, presumably aware of the risk of litigating derivative claims in that context." The Court cited to no evidence in the record, because there is none, that Plaintiffs were aware of the challenged transactions prior to the closing of the Merger. Nor is there any evidence in the record that the Plaintiffs knew of the impending Merger. The only competent evidence in the record is that Plaintiffs had no idea about the

challenged transactions until they received an information statement *after* the closing of the Merger. It is impossible to determine how this factual error may have affected the trial court's analysis, so the matter should be remanded to allow the trial court to consider the correct facts.

The combined effect of the Court of Chancery's holdings leads to a public policy disaster by creating a road map for bad actors to fleece minority stockholders without fear of liability. A malevolent entity could (i) acquire a majority interest in a publicly-traded entity, (ii) deregister and delist the entity to avoid public disclosure requirements, (iii) cause the company to engage in undisclosed self-dealing transactions expropriating economic and voting power from the minority to the controller, (iv) cause the company to merge with another entity and extinguish the rights of the stockholders to challenge that expropriation of economic and voting power, and (v) avoid any liability for the self-dealing transactions. Whatever misgivings the Court may have about the viability of *Gentile*, this case does not justify a change in the law.

STATEMENT OF FACTS

With one material exception discussed below, the Almond Appellants have no quarrel with the facts as found by the Court below. Thus, the factual recitation below relies largely on the factual recitation in the Opinion except where indicated. And because the issues on appeal are more narrow than those before the Court of Chancery, the factual recitation focuses mostly on the challenged transactions and not the multitude of defects in almost every significant transaction DWR entered into after Glenhill took over.

A. The Parties

The Almond Appellants were stockholders of DWR at the time the Merger. (Op. 4.) The Almond Appellants owned approximately 9.6% of DWR's common stock in 2009 and continued to acquire additional DWR shares through July 2014. (Id.)

DWR was a Delaware corporation and indirect wholly-owned subsidiary of HMI with its principal place of business in Stamford, Connecticut. (*Id.*) HMI is a Delaware corporation with its principal place of business in Zeeland, Michigan that produces office furniture, equipment, and home furnishings. (*Id.*)

Glenhill Advisors, LLC, Glenhill Capital, L.P., Glenhill Capital Management, LLC, Glenhill Concentrated Long Master Fund, LLC (the "Long Fund"), Glenhill Special Opportunities Master Fund, LLC (the "Overseas Fund,"

and, with the entities, "Glenhill") are part of a fund complex controlled by Glenn Krevlin (together with Glenhill, the "Glenhill Defendants"). (*Id*. 5.) At all relevant times, Krevlin had sole investment and voting power over all DWR shares held by Glenhill. (*Id*.) Krevlin was the single largest investor and sole portfolio decisionmaker at all relevant times for the Long Fund which was an investment fund primarily for individuals. (*Id*.) The Overseas Fund held assets of at least $750 million and had a variety of investors. (*Id.*)

Glenhill appointed William Sweedler to the DWR board in August 2009. He is the managing member of Windsong Brands, an investment and restructuring company. (*Id*. 6)

Windsong DWR, LLC ("Windsong I") and Windsong DB DWR II, LLC ("Windsong II") were special purpose vehicles formed, respectively, in May 2010 and July 2012 for investments in DWR. (*Id*.) The Individual Defendants were were the directors of DWR from January 2010 until the Merger. (*Id*.)

B. Glenhill Acquires a Majority Interest in DWR

In May 2009, DWR's lender, Wells Fargo, informed DWR that it needed a capital infusion of $10 million to $15 million to maintain its line of credit. (*Id*. 7.) DWR was desperate to avoid a stockholder vote on whatever transaction was required to meet this financing goal. On May 29, 2009, DWR applied to NASDAQ for a financial viability exception to allow a transaction to close without

stockholder approval. (*Id.*) NASDAQ rejected that request, so DWR voluntarily delisted its stock from NASDAQ effective July 16, 2009. (*Id.*) While DWR was delisting, it also was in discussions with Glenhill for a capital infusion. At the time, Glenhill held approximately 17.2% of DWR's outstanding common shares. (*Id*. 7-8.)

On July 20, 2009, DWR announced that it had entered into a definitive agreement with Glenhill pursuant to which Glenhill would invest $15 million in DWR in exchange for 15.4 million shares of DWR common stock for $0.15 per share and 1,000,000 shares of Series A Preferred Stock (the "Series A Preferred"), for $12.69 per share constituting a 91.33% ownership stake in DWR. (*Id*. 8.) Glenhill also negotiated for the right to appoint three directors of DWR. (*Id*. 12.) The transaction closed on August 3, 2009. (*Id*. 8.)

The terms of the Series A Preferred were governed by the Certificate of Designation of Preferences, Rights and Limitations of Series A 9% Convertible Preferred Stock of Design Within Reach, Inc. (the "Series A COD"). (*Id*. 9.) For purposes of this appeal, the relevant portions of COD are the payment in kind provisions and the conversion formula. As the Court below recited:

> PIK Dividend. Series A Preferred Holders had the right to receive cumulative dividends at the rate of 9% per year, compounding annually to be paid-in-kind in the form of additional shares of Series A Preferred (the "PIK Dividend"), with the option to let the PIK Dividend (i)

> accrue to the next "Dividend Payment Date" or (ii) to accrete and increase the Stated Value.

(*Id*. 9.) The conversion formula allowed holders of Series A Preferred to convert their shares into shares of common stock. Upon conversion, the holder was entitled to receive a number of common shares determined by multiplying the number of shares converted by the "Stated Value" then dividing by the "Conversion Price" both of which values were set forth in the Series A COD and subject to adjustment.[1] (*Id*. 10.)

C. Glenhill Takes Control of DWR

After closing of its investment in DWR, Glenhill initially appointed Krevlin, Sweedler and David Rockwell as directors. The then-Chief Executive Officer ("CEO") Ray Brunner, and Peter Lynch were the other directors. (A0046.) Rockwell and Lynch left the board in 2009. (A0361-62.)

After taking control, Sweedler and his partner in Windsong Brands, Stuart Jamieson, acted as interim management for DWR, evaluating the company and proposing ways to cut costs. (Op. 13.) Sweedler agreed to take on this task without agreement on compensation. (*Id*. 13.)

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[1] The adjustment provisions of the Series A COD challenged by Mr. Franklin in his appeal are not directly relevant to the issues raised by the Almond Appellants. The issuances awarded in 2013, however, are evidence of the lackadaisical approach to corporate governance.

In October 2009 Krevlin decided to terminate Brunner as CEO and removed him from the board. (A0053; A0360.) Also in October, DWR, at the direction of Krevlin, filed a Form 15 with the SEC terminating the registration of DWR's common stock, purportedly to save money. (Op. 13.) As a result of the delisting from NASDAQ and deregistration, DWR no longer had any public reporting requirements.

Shortly after firing Brunner, Sweedler, knowing Krevlin needed a new management team, introduced Krevlin to Edelman and McPhee. After negotiations, on December 14, 2009, Edelman and McPhee entered into employment agreements with DWR to be the CEO and COO, respectively, of DWR beginning in January 2010. (*Id*. 15.) The employment agreements provided Edelman and McPhee options to purchase 4% and 3% of DWR's equity, respectively. Edelman and McPhee both testified that they understood their options contained anti-dilution protections, but as the Court below found "the agreements did not state that Edelman or McPhee would receive anti-dilution protection. (*Id*. 15.) After starting at DWR in January 2010, Krevlin named Edelman and McPhee directors. From January 2010 through the date of the Merger, Krevlin, Edelman, McPhee and Sweedler were the directors of DWR.

D. The Windsong Note

DWR used about half of the $15 million it received from Glenhill to pay down its line of credit and used the rest for operating losses, outstanding invoices and building inventory. (A0363.) By January or February 2010, however, the Board, now consisting of the Individual Defendants, decided that DWR needed to raise $5 million. (A0364; A0054.) The process the Individual Defendants followed to raise this money fell far below the standards expected of directors of a Delaware corporation. As the Court below found:

> Shortly after McPhee and Edelman joined the Company in January 2010, the Board began to consider a capital raise. On February 12, 2010, Krevlin emailed Edelman: "Would be great to raise only 5mil[.] Sounds like we can round that up [b]etween you john and friends." That month, Edelman contacted four potential investors: "one of [his] relationships," his co-investor in another project, his brother, and another contact, but "didn't really go through [the investment with them] at length." Sweedler testified that he had discussions with a potential Canadian investor (Knightsbridge Capital), but it wanted terms that were more dilutive than the 2009 Transaction and a higher interest rate.
>
> On March 11, 2010, Seth Shapiro, a senior analyst at Glenhill emailed Krevlin that the Company was "[n]ot in a real rush" to raise capital, "given [Edelman and McPhee] cant close until early April and we don't have cash need before then."
>
> According to Krevlin, the Board did not seek funding from other potential investors because "it would be extremely difficult to get anyone comfortable with [the Company's] precarious situation," given the "significant

> unknown liabilities" in buying out leases for closed and underperforming stores and a potential multi-million-dollar liability arising from "wage and hour" claims regarding the classification of sales associates as exempt employees to avoid paying overtime wages.

(Op. 16-17.)

Given this "process," it is unsurprising that the Individual Defendants decided that they would provide DWR with the funds in what became the "Windsong Note."[2] And it is equally unsurprising that Court below concluded that the "terms of the Windsong Note were the product of a conflicted and deficient process." (*Id*. 17.) Krevlin tasked Seth Shapiro, a senior analyst at Glenhill and Krevlin's subordinate, to negotiate the transaction on behalf of DWR even though Shapiro knew that Krevlin would be one of the investors. (*Id*.) Across the table sat Sweedler, who negotiated on behalf of himself, Jamieson, McPhee, Edelman and (purportedly) the Long Fund. (*Id*. 17-18). The Board did not consult with an outside financial advisor. (*Id*.)

In fact, Sweedler dictated the terms of the note, whereby Windsong I would loan DWR $5 million in exchange for a convertible loan secured by a first lien on the Company's intellectual property. (*Id*. 18.) The Court below also found that "[t]here were no real price negotiations" and the Windsong Note was priced on the

[2] As the Plaintiffs argued below, the Individual Defendants' willingness to invest in DWR at this time – when they were the only ones with knowledge of all of the potential risks –is inconsistent with their litigation position that DWR was in such a perilous financial state that no one else would want to invest in the company.

same terms as Glenhill's initial investment. (*Id*. 18.) "That is, the Windsong Note 'was convertible into common stock at the same exchange ratio as the [2009 Transaction]." (*Id*.) Krevlin admitted at trial that even though he purportedly had no role in the negotiations, "the way this note was set up is that, basically, the conversion would always be tied to the same price of the conversion of the original '09 security so that they would move in lockstep in terms of the convertible price." (*Id*. 19.)

To effectuate the transaction, the Individual Defendants and Jamieson formed Windsong I with the following capital contributions: (i) Edelman – $2 million for 40%; (ii) Windsong DB, LLC (Sweedler's entity) – $1.15 million for 23%; (iii) the Long Fund – $1 million for 20%; (iv) McPhee – $750,000 for 15%; and (v) Jamieson Investments, LLC – $100,000 for 2%. Windsong I and the Company entered into a Note Purchase and Security Agreement dated as of May 18, 2010. The Windsong Note was convertible into shares of common stock according to a matrix attached to the loan document that mirrored the conversion ratios of the Series A Preferred, just as Krevlin said. (Op 19.) The Windsong Note even had a provision to adjust the conversion matrix to account for a reverse stock split. (*Id*. 20.)

On May 24, 2010, the Company issued a Notice of Annual Meeting of Stockholders (the "2010 Meeting Notice"). (*Id*. 20.) The Court below noted that

the 2010 Meeting Notice disclosed that the Company had entered into the Note Purchase Agreement and that the Individual Defendants were "affiliated" with Windsong I. That is the only reference to, or description of, the 2010 Meeting Notice by the Court below. The Court below did not make a finding that this disclosure was sufficient to put Plaintiffs on notice of the Windsong Note.

E. The Brands Grant

As noted above, after the 2009 Transaction, Windsong Brands provided management analysis and advice to DWR. The board requested that Windsong Brands provide this advice after the then-CEO, Ray Brunner, provided the Board with "unrealistic" numbers in the first board meeting after the 2009 Transaction, and the CFO told the board after the meeting that Brunner's presentation did not include "the real numbers." (*Id*. 12.) At the request of the board, Windsong Brands sent a team to the Company's offices in San Francisco to investigate these issues. Windsong Brands' investigation revealed other potential malfeasance by Brunner, so the board suspended him in the end of August 2009, with Jamieson taking over as interim CEO, and fired him in October 2009. With Jamieson as acting CEO, Windsong Brands performed a "top-to-bottom review of DWR's business" and evaluated how to reduce costs. (*Id*. 13.) Windsong Brands continued to provide these management services until Edelman and McPhee assumed their roles in early 2010.

Windsong Brands performed these services without a prior agreement on compensation. After Edelman and McPhee took control, Sweedler began negotiations with Krevlin on compensation for Windsong Brands' work. Sweedler initially asked for a 10% equity interest, but he and Krevlin eventually agreed on a grant of 54,796 restricted shares, or a 1.5% interest in the Company that could not be sold but would be fully vested upon a change in control of the company (the "Brands Grant"). (*Id*. 14.) Although Sweedler said he began negotiations with Krevlin right away after Edelman and McPhee started, the document memorializing the Windsong Grant is dated September 28, 2011, 18 months later. In response to questioning from the Court, Sweedler could not remember when in that time span he and Krevlin finally agreed on the terms. (A0370-72.) Finally, similar to the employment agreements of Edelman and McPhee, the Windsong Grant does not contain anti-dilution protection (Op. 14.) but Sweedler testified that he and Krevlin agreed to such anti-dilution protection. (A0368-69.)

F. The 2012 Financing and Anti-Dilution Grants

At the end of 2011, the Company's prospects had improved dramatically, to the point where the Company was seeking "offensive capital" to deploy rather than taking "defensive" positions. (Op. 24.) During the first half of 2012, the Board discussed a private placement to raise $2.5 million. (*Id.*) The Company consummated the private placement on June 19, 2012 (the "2012 Financing"). (*Id.*)

Described as a "holistic" solution by Krevlin, the 2012 Financing consisted of (i) the sale of common stock and granting to options to raise $2.5 million to the Individual Defendants; (ii) extending the maturity date of the Windsong Note; and (iii) entering into an agreement requiring that the Windsong Note and the Series A Preferred by converted on the same date – October 3, 2013. (*Id*. 24-26.)

Like the Windsong Note, the 2012 Financing was a transaction between the Individual Defendants and the Company, so there should be no surprise that the Court found the process leading to "the 2012 Financing was the product of a conflicted and deficient process." (*Id*. 27.) The Court below made the following factual findings regarding the conflicted and deficient process that led to the 2012 Financing:

> There are no minutes reflecting the Board's consideration of the 2012 Financing, and it never hired an outside financial advisor. Shapiro again was tasked by Krevlin to negotiate on behalf of the Company against Sweedler, who represented the Director Defendants, including Krevlin. Shapiro and Sweedler did not negotiate vigorously. There is no documentary evidence of price negotiations, and Sweedler admitted that he and Krevlin had "two securities that were bumping up against each other," i.e. Glenhill's Series A Preferred and the Windsong Note, and "were trying to protect each other's interest at the end of the day."
>
> Krevlin, Shapiro, and Sweedler testified that at least two data points were used to determine the price of the 2012 Financing, which implied a $27 million valuation of the Company: (i) the indication of interest from Herman Miller at a $25 million to $30 million enterprise value;

> and (ii) Glenhill's internal valuation of the Company indicating a value of $4.41 per share as of December 31, 2011. No documents confirm that Shapiro and Sweedler actually used those data points to negotiate the price per share.

(*Id*. 27-28) (internal citations omitted).

Just two days before closing on the 2012 Financing, the Company granted an additional 19,654 restricted shares of common stock to Windsong Brands, and awarded Edelman and McPhee 55,459 and 41,594 options, respectively, to purchase common stock in the Company (the "Anti-Dilution Grants"). (*Id*. 28.) The Company authorized these grants to satisfy its purported anti-dilution obligations to Edelman and McPhee in their employment agreements and to Windsong Brands in the Brands Grant to offset dilution caused by the PIK Dividend and other dilutive transactions since the respective agreements were executed. (*Id*.) The Court below found, however, that neither the employment agreements nor the Brands Grant contained any anti-dilution protection. (*Id*.)

G. The October 2013 Conversions

Although Sweedler and Krevlin had worked so hard on the details of the 2012 Financing to prevent either from getting the financial upper hand as a result of the PIK Dividend or interest on the Windsong Note,[3] they completely forgot about the agreement to convert both instruments on October 3, 2013. It was not

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[3] See Op.

until October 8 that Shapiro asked Joshua Englard, Esq. of Ellenoff Grossman, counsel for DWR, to effectuate the conversions. (*Id*. 29.) And it was not until October 22, 2013 that Englard sent a notice of conversion for the Windsong Note and for the Series A Preferred (the "Series A Conversion Notice") by email to Lorraine DiSanto, then CFO of DWR. (*Id*.) The Series A Conversion Notice purported to convert 1,432,397 Series A Preferred shares into 3,936,571 common shares. (A0057.) As detailed more fully in Franklin's Opening Brief, the Series A Conversion Notice, and the entire conversion process, was rife with errors including, without limitation, the fact that in the conversion the Company issued more shares than it was authorized to issue in violation of the clear terms of the Series A COD and, when the Company discovered this error, it attempted to backdate written consents approving an increase in the number of authorized shares to October 3 to make it appear that the conversions occurred when they were supposed to occur.

H. The Merger

In November 2013, just three months after the 2012 Financing, the Board hired Financo LLC ("Financo"), a financial advisor, to explore a sale of the Company. (*Id*. 31.) Financo's efforts led to the Merger. The Merger, which Glenhill approved by written consent on behalf of the DWR stockholders, closed

on July 28, 2014. (Op. 32.) The Company did not send a notice of the Merger until August 2014 (the "Merger Notice"). (*Id*. 33.)

The Merger Notice disclosed no additional facts about the Windsong Note. And it informed the DWR stockholders for the first time about the 2012 Financing, the Brands Grant and the Anti-Dilution Grants. (A0072). Even then, the facts were not in the Merger Notice itself. Instead, they only could be found in the financial statements attached to the Merger Notice and the notes to such statements. But because the Merger closed *before* the Company sent the Merger Notice, the stockholders of DWR never even knew the transactions occurred (the 2012 Financing and Anti-Dilution Grants) or enough facts to know that the transaction should be challenged (the Windsong Note). (Op. 32-33.)

I. The Opinion

Although Glenhill and the Individual Defendants had asserted an affirmative defense based on 8 *Del. C.* § 327 in their various Answers to the complaints filed in this matter, they did not file a motion to dismiss. (*Id*. 39.) Nor did Glenhill and the Individual Defendants file a motion for summary judgment based on this defense at any time during the litigation, even when HMI filed its own motion for summary judgment on the Section 204 and 205 issues. Instead, Glenhill and the Individual Defendants argued the issue for the first time their Pre-Trial Brief. When asked by the Court at post-trial argument why they did not assert the issue

before, Glenhill and the Individual Defendants explained that the law was in flux, and the Court told the parties at the hearing on HMI's motion for summary judgment that it would not consider further pre-trial motions on the merits.

In the Opinion, the Court held that the claims challenging the Windsong Note, 2012 Financing and the Anti-Dilution Grants were derivative, not direct. (*Id*. 72.) Therefore, despite concluding that both the Windsong Note and 2012 Financing were the products of a "conflicted and deficient process" and there was no anti-dilution agreement with the recipients of the Anti-Dilution Grants, because of the Merger, Plaintiffs did not have standing to bring any claims challenging these transactions. (*Id*. 27.) Thus, the Court did not address any of these claims on the merits.

<u>ARGUMENT</u>

I. THE COURT BELOW ERRED IN HOLDING THAT PLAINTIFFS LACKED STANDING

A. Questions Presented

Whether the Court of Chancery erred in concluding that Plaintiffs' lost standing as a result of the Merger to bring their claims for breach of fiduciary duty challenging transactions that were the product of a conflicted and deficient process? (A0243; A0326-33.)

B. Scope of Review

Where, as here, the Court of Chancery's ruling on standing implicates rulings of law, it is reviewed *de novo*. *Schoon v. Smith*, 953 A.2d 196, 200 (Del. 2008). While the trial court's factual conclusions are accepted if they are the product of an orderly and logical deductive process, "in an appropriate case, this Court may review *de novo* mixed questions of law and fact … and in certain cases make its own finding of fact upon the record below. *Zirn v. VLI Corp.*, 681 A.2d 1050, 1055 (Del. 1996) (internal citations omitted).

C. Merits of Argument

The Court of Chancery reached the wrong conclusion about Plaintiffs' standing for three reasons. *First*, the Court of Chancery erred in holding that a plaintiff cannot state a direct claim under *Gentile* when there is a pre-existing controlling stockholder without proving the controlling stockholder agreed with

other stockholders to share or impose limits on its own control power. *Second*, the Court of Chancery incorrectly concluded that because Krevlin was nominally diluted by the challenged transactions, there was no transfer of economic or voting power from the minority stockholders. *Finally*, the Court justified its holding by concluding that Plaintiffs had not been "ambushed" and "chose" to file their fiduciary duty claims after the Merger closed. The Court cited no factual basis for this conclusion and, in fact, there is none. Moreover, the Court's analogy to *El Paso Pipeline GP Co., LLC v. Brinckerhoff,* 152 A.3d 1248 (Del. 2016), was wrong. Indeed, the only logical conclusion from the record is that the Plaintiffs knew nothing of these transactions until they received the Merger Notice after the Merger closed, and, under the Court's holding, Plaintiffs had already lost standing.

1. *Gentile* Does Not Require a Plaintiff to Prove a Pre-Existing Controller Was Part of a Group to State a Direct Claim

It is undisputed that Glenhill controlled DWR and Krevlin controlled Glenhill. But because other stockholders – Edelman, McPhee and Sweedler – received the benefits of the challenged transactions, the Court below focused its and the parties' attention on the unique question of whether the Individual Defendants could constitute a control group for *Gentile* purposes. By framing the issue in this manner, the Court below overlooked the very facts of *Gentile* and one of the key holdings of *Gentile* and its progeny.

As the Court is well aware, in *Gentile* the controlling stockholder of SinglePoint Financial, Inc. ("SinglePoint"), Rossette also loaned the company substantial funds. Rossette decided that the size of the loans was harming the company's ability to obtain a third-party investment, so he wanted to convert his debt into stock. Although the debt instruments had a conversion ratio of $.50 of debt per share, Rossette, acting for himself and the only other director, Douglas Bachelor, purporting to act on behalf of the company, agreed that Rossette could convert over $2 million of debt for $.05 of debt per share. The company's stockholders approved an amendment to the certificate of incorporation increasing the number of authorized shares so that Rossette could consummate the conversion, but they were not told of the proposed conversion. As a result of the conversion, Rossette's percentage interest rose from 61.19% to 93.49%

After the conversion, the company entered into a merger transaction with its only direct competitor. The combined company survived for only 18 months before filing a bankruptcy petition. Shareholders of SinglePoint filed an appraisal action, and although the Court of Chancery found that the fair value of a share of SinglePoint was 110 times the per share value offered in the merger, the Court of Chancery refused to consider the shareholder's "share dilution claim" in the context of an appraisal action.

The SinglePoint shareholders then filed a plenary action alleging a breach of fiduciary duty in connection with the conversion. The Court of Chancery granted defendants' motion for summary judgment on the grounds that the claim was derivative.

On appeal, this Court held that plaintiffs' claim of overpayment to a controlling stockholder was derivative and direct in character. Although the company suffers a harm through the "underpayment" by the controller, the stockholders suffer their own harm. The stockholders' separate harm is "an extraction from the public shareholders, and a redistribution to the controlling shareholder, of a portion of the economic value and voting power embodied in the minority interest." *Gentile*, 906 A.2d at 100.

Just a few months later, the Court faced a similar question in *Gatz v. Ponsoldt*, 925 A.2d 1265 (Del. 2007). In *Gatz*, a *de facto* controller used his control over the company to orchestrate a complex series of transactions by which the controller received cash and cancellation of a note issued as consideration for exercise of an option to purchase the company's stock, and a third-party ended up with a majority of the outstanding shares of the company.

The defendants argued, among other things, that the claims arising from the recapitalization could not be direct because unlike in Gentile, the expropriation of the minority's economic and voting power did not benefit the controller and

instead went to the third party that held no shares in the company before the recapitalization. In other words, majority control was transferred in an arm's length transaction to a non-fiduciary third party with no previous stock ownership and the now-former controlling shareholder received no voting power or economic value taken from the public shareholders.

This Court disagreed. The Court stated that had the transactions in the recapitalization been broken apart so that the controller first received the controlling interest in the company and then transferred it to the third-party, then the controller clearly would have resulted in a direct claim under *Gentile*. And simply because the transactions were structured and timed to occur simultaneously does not mean that the shareholders would lose their entitlement to bring a direct claim. *Gatz*, 925 A.2d at 1280. While the "classic" structure results in the controller receiving the expropriated economic power and voting control, that same paradigm identified in Gentile can result where "the ultimate transferee is a third party, with the controlling stockholder being an intermediary that transfers the benefits of its expropriation to the ultimate beneficiary in exchange for cash or other equivalent value." *Id*. at 1281. The Court made clear that

> [i]n both cases the fiduciary exercises its control over the corporate machinery to cause an expropriation of economic value and voting power from the public shareholders. That the fiduciary does not retain the direct benefit from the expropriation but chooses instead to convert that benefit to cash by selling it to a third party, is

> not a circumstance that can justify depriving the injured public shareholders of the right they would otherwise have to seek redress in a direct action.

Id.

Thus, to state a direct claim there must be expropriation of economic value and voting power from the minority by the controller for his or her benefit. The controller need not retain the expropriated asset for the plaintiff to state a direct claim. He can transfer the asset to a third party in exchange for cash or other value and the claim will still be direct.

The Court below, however, found that when there is a preexisting controlling stockholder, the plaintiff stockholder must show that the controller agreed to "share with other stockholders, or to impose limitations on, its own control power (such as through a voting agreement) for some perceived advantage as part of a legally significant relationship with the other stockholders." (Op. 64.) The requirement, however, is too narrow under *Gatz*.

There is no doubt that Krevlin used his control over DWR to expropriate voting and economic power from the minority. Krevlin did not retain the expropriated asset, but instead used it to satisfy obligations – express or otherwise – to his management team. For example, Edelman and McPhee had always understood they were to invest in DWR (A0365-66.) Sweedler told Krevlin he would only invest if the investment had security, preferably DWR's intellectual

property. (A0367.) Rather than selling Glenhill's shares to Sweedler, Edelman and McPhee at a discount, Krevlin caused the Company to do so for his own benefit. Under *Gatz*, satisfying Krevlin's promises to Sweedler, Edelman and McPhee conferred a benefit on Glenhil sufficient to satisfy *Gentile*, even though Glenhill did not retain the actual voting and economic power.

The form of the transaction should not determine Plaintiffs' standing. Krevlin could have engaged in these transactions by himself and then transferred the interests to Sweedler, Edelman and McPhee. Instead, similar to *Gatz*, he collapsed everything into a simultaneous transaction to accomplish the same result. And just as in *Gatz*, the Court should not exalt form over substance here simply because the Windsong Note was issued to Windsong I or the Individual Defendants (or their designees) were the purchasers in the 2012 Financing.

These transactions must have provided Krevlin a benefit because there is no other explanation for why he allowed them to occur. Nothing happened at DWR without Krevlin's approval. Aside from Krevlin's structural control over DWR through his voting control, Krevlin also signed off personally on all major decisions. It was Krevlin who negotiated Edelman and McPhee's employment contracts. It was Krevlin who Sweedler approached to negotiate the Brands Grant. It was Krevlin who instructed his subordinate, Shapiro, to "negotiate" on behalf of DWR against Sweedler. Thus, there can be little doubt that Edelman, McPhee and

Sweedler were beholden to Krevlin. And it was Krevlin who, despite purportedly delegating the negotiating responsibilities to Shapiro, knew enough about the negotiations of the Windsong Note and 2012 Financing to make sure that the Windsong Note would not dilute the Series A Preferred. Even if all Krevlin received was the benefit of shifting some of the risk to others, that benefit is sufficient to satisfy the *Gentile* analysis.

2. Glenhill's Nominal Dilution Does Not Mean That It Did Not Expropriate Economic and Voting Power From the Minority

For the same reason, the Court's conclusion that Glenhill was diluted and, therefore, it did not receive the benefit of the expropriated economic value and voting power misses the point. Krevlin used his power over the corporate machinery to expropriate economic value and voting power from the minority stockholders of DWR. Under *Gatz*, Krevlin did not need to retain that expropriated asset. Indeed, in *Gatz* the controller ended up with *no* shares in the entity.

Instead, the core question under *Gentile* and *Gatz* is whether the controller used the expropriated asset for its own benefit irrespective of whether the controller kept the asset for itself. And under *Gatz*, the Court looks to the substance, rather than the form, of the transaction to determine whether Gentile applies. *Gatz*, 925 A.2d at 1281. Here, although the other Individual Defendants

participated in the challenged transactions, they did so only with the permission and consent of Krevlin. Krevlin could have had them removed as directors and, in the case of Edelman and McPhee, as officers at any time, for any reason. Krevlin just as easily could have made the investment directly and then allowed the other Individual Defendants to invest in Windsong I and or sold the shares and options issued in the 2012 Financing to the Individual Defendants. The structure of the transaction should not affect the rights of the minority stockholders to seek redress.

3. The Record Does Not Support The Conclusion That Plaintiffs Chose to File Their Claims After the Merger Closed

Finally, although the Court below acknowledged that because of its holding, "some of the claims that will be extinguished here involved self-dealing transactions in which all members of the Board were conflicted (e.g., the Windsong Note and the 2012 Financing) and which otherwise would be subject to entire fairness review" the Court below attempted to justify that result by blaming Plaintiffs for sitting on their rights. The Court below concluded its standing analysis by stating:

> And at least in this case, unlike in *El Paso*, plaintiffs cannot claim to be ambushed. They did not assert any of the Overpayment Claims in real time but chose to file them after the Merger closed, presumably aware of the risk of litigating derivative claims in that context.

(Op. 72-73). The first sentence misreads the facts in *El Paso* and the second has no basis in the record. As a result the entire analysis of the Court below is suspect.

The plaintiffs' situation in *El Paso* bears no resemblance to the Almond Appellants. The plaintiffs in El Paso were not "ambushed" by a merger that they had no notice of before it closed. Those plaintiffs had an active litigation scheduled for trial when the defendant entity announced the proposed merger. The plaintiffs sought an expedited trial so that their claims could be decided before trial, but the court decided to address the standing issue after trial. The merger extinguishing plaintiffs' claims closed shortly after the trial.

Here, it is undisputed that Plaintiffs did not receive the Merger Notice until *after* the Merger closed. (A0072; A0375-76; A0220-21.) And there were only 11 days between when the Merger was publicly announced (July 17, 2014) and when it closed (July 28, 2014). Even then, the Merger Notice did not describe in any detail the Windsong Note, the 2012 Financing, the Brands Grants or the Anti-Dilution Grants. Only by reading the financial statements attached to the Merger Notice and the notes to those statements did Plaintiffs learn about the conversion of the Windsong Note and the Series A Preferred, the issuance of shares in the 2012 Financing (but *nothing* about the 2012 Financing itself, even in the note on Related Party Transactions, except a reference to a purchase by existing shareholders of

$2,500,000 of common stock) the Brands Grant (identified only as grants to a consultant), and the award of options to "management."

Thus, the Court below was incorrect in stating that the plaintiffs in *El Paso* were "ambushed" by the merger there. Those plaintiffs had an existing lawsuit and months of notice. If anyone was ambushed, it was the Plaintiffs here. They had 11 days of notice before the Merger closed and, in all events, did not learn of many of the transactions challenged here until long after the Merger closed.

The same result obtains for the challenge to the Windsong Note, but for different reasons. First, Almond and Franklin both testified that they did not receive a copy of the 2010 Meeting Notice. (A0373-74; A0219.) But even if they had, the disclosure in the 2010 Meeting Notice regarding the Windsong Note fell far short of putting shareholders of DWR on notice that the Windsong Note deserved further scrutiny.

First, the Windsong Note was not a matter submitted to the stockholders for approval at the 2010 Annual Meeting. As a result, the description of the Windsong Note in the 2010 Meeting Notice did not occupy a prominent place in the document. In fact, the description of the Windsong Note is buried on half of page 30 of the 68 pages of materials in the 2010 Meeting Notice.

Second, although the Court below acknowledged that the 2010 Meeting Notice disclosed that the Individual Defendants were "affiliated" with Windsong I,

that is the extent of the disclosure. The Court below failed to acknowledge in the Opinion that the 2010 Meeting Notice did not disclose that the Individual Defendants controlled Windsong I and owned 98% of its membership interests. Further, the 2010 Meeting Notice discloses that the Windsong Note is secured by the Company's assets, but it does not disclose that it is secured by a first lien on the Company's intellectual property, an asset that Sweedler considered to be the Company's most valuable property. And, of course, the 2010 Meeting Note does not disclose *anything* about the process the Board engaged in to find potential investors or the "vigorous" negotiations between Shapiro and Sweedler. Finally, the 2010 Meeting Notice did contain the conversion matrix for the Windsong Note, but given that the Company was asking the stockholders to approve a reduction in the number of authorized shares to 15 million shares of common stock, a conversion matrix showing conversion of the Windsong Note into 55 million shares is meaningless.

Put simply, the Opinion cites to no evidence that any of these transactions were disclosed properly to the stockholders of DWR "in real time" or at any time before the Merger. That is because there is no evidence in the record to support this conclusion. In fact, the only competent evidence in the record is that the stockholders did not know that the Individual Defendants were the sole investors in Windsong I, and therefore the Windsong Note until receiving the Merger Notice.

And the shareholders learned of the 2012 Financing, Brands Grant and Anti-Dilution Grants for the very first time in the Merger Notice.

Where a key factual finding was based "either on incompetent evidence or no evidence at all, the Court must conclude that the trial court's findings were not 'the result of a logical and orderly deductive process.'" *State v. Crespo*, 2009 WL 1037732, at *6 (Del. Super. Apr. 17, 2009). Where the trial court's legal conclusion is infected with a plainly incorrect assessment of the evidence, it is impossible for an appellate court to determine whether the trial court, once made aware of its error, would have arrived at the same conclusion. *State v. Douglas*, 441 P.3d 1050, 1053 (Kan. Supr. 2019). As the Supreme Court of Kansas held, "[i]n such circumstances, the wisest course for the appellate court is to reverse and then gave the [trial court] another chance to review the record and explain himself or herself." *Id.*

* * *

Reversing the Court of Chancery's decision here would not be inconsistent with this Court's holding in *El Paso* "declin[ing] the invitation to further expand the universe of claims that can be asserted 'dually.'" *El Paso*, 152 A.3d at 1246. The Court of Chancery has taken this Court's admonition to seriously and, in every case since El Paso, found that the claims at issue were not direct under Gentile for a variety of reasons. *E.g., Reith v. Lichtenstein*, 2019 WL 2714065, at *11-*12

(Del. Ch. June 28, 2019) (claim challenging issuance of preferred stock and equity grants not dual-natured because common stockholders not diluted); *Sheldon v. Pinto Tech. Ventures, L.P.*, 2019 WL 336985, at *11 (Del. Ch. Jan. 25, 2019) (addressing without deciding whether plaintiff need plead existence of a controlling stockholder to assert a direct claim under *Gentile*); *Klein v. H.I.G. Capital, L.L.C.*, 2018 WL 6719717 (Del. Ch. Dec. 19, 2018) (claim not dual-natured because common stockholders held same percentage of common stock after issuance of preferred stock, so transaction did not transfer economic power as contemplated by *Gentile*); *Cirillo Family Trust v. Moezinia*, 2019 WL 3388398, at *16 (Del. Ch. July 11, 2018) ("the *Gentile* paradigm only applies when a stockholder *already possessing majority or effective control* causes the corporation to issue more shares to it for inadequate consideration.") (emphasis in original; citations omitted)*Mesirov v. Enbridge Energy Co.*, 2018 WL 4182204, at *8-*9 (Del. Ch. Aug. 29, 2018) (claim based on partnership agreement was direct); *Sciabacucchi v. Liberty Broadband Corp.*, 2018 WL 3599997, at *9 (Del Ch. July 26, 2018) (dilution claim not dual-natured under Gentile due to absence of controlling stockholder before transaction); *Dietrichson v. Knott*, 2017 WL 1400552, at *5 (Del. Ch. Apr. 19, 2017) (claim not dual-natured because plaintiff did not allege dilution of voting power);

None of the reasoning in the cases cited above applies to the claims here. Glenhill was a controlling stockholder before the challenged transactions. There is no question that Glenhill expropriated economic *and* voting power from the minority. And just like in *Gatz*, the controller used that expropriated power for its own benefit even if it did not keep the stock issued for itself.

Reversal in this case would not expand the universe of claims, but instead would fit comfortably within the existing law. Indeed, this is the exact type of scenario where *Gentile* was meant to apply. Under cover of "going dark" the controller expropriated economic and voting power from the minority stockholders of the Company. There was no reason for the stockholders to know about these transactions. After all, the Company did not send out notice of stockholder action as required by 8 *Del. C.* § 228, and the Company's performance was otherwise improving. It was not until *after* the Merger that the minority learned that its percentage interest in the Company was far smaller than they thought due to several transactions that were the product of a conflicted process.[4] Finding that Plaintiffs have standing here simply would not expand the "universe of claims" that can be dual-natured under *Gentile*. That finding would be faithful to *Gentile*.

[4] The Plaintiffs only learned the extent to which the process was deficient through discovery.

CONCLUSION

Although the Court below found that Windsong Note and 2012 Financing were the products of a conflicted and deficient process and would be subject to entire fairness review, because the Court of Chancery found that plaintiffs lacked standing to bring claims challenging those transactions, the Court below never completed the entire fairness analysis. This Court should reverse the decision of the Court below that Plaintiffs lacked standing and remand with instructions to the Court of Chancery to complete the entire fairness analysis. Anything less will create a roadmap for bad actors to fleece minority stockholders without fear of reprisal.

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