

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

CRAIG LONDON and JAMES HUNT,)
individually and derivatively on behalf of)
MA FEDERAL, INC., d/b/a iGov, a)
Delaware corporation,)

Plaintiffs,)

v.)

Civil Action No. 3321-CC

MICHAEL TYRRELL, PATRICK)
NEVEN, and WALTER HUPALO,)

Defendants)

and)

MA FEDERAL, INC., d/b/a iGov, a)
Delaware corporation,)

Nominal Defendant.)

MEMORANDUM OPINION

Date Submitted: May 8, 2008

Date Decided: June 24, 2008

David A. Jenkins, Michele C. Gott, and Kathleen M. Miller, of SMITH, KATZENSTEIN & FURLOW LLP, Wilmington, Delaware, Attorneys for Plaintiffs.

Elizabeth M. McGeever and J. Clayton Athey, of PRICKETT, JONES & ELLIOTT, P.A., Wilmington, Delaware; OF COUNSEL: John C. Hayes, Jr. and Kimberly J. Jandrain, of NIXON PEABODY LLP, Washington, District of Columbia, Attorneys for Defendants.

CHANDLER, Chancellor

On October 31, 2007, plaintiffs Craig London and James Hunt filed their derivative complaint alleging that defendants Michael Tyrrell, Patrick Neven, and Walter Hupalo were harming the company in which all parties own shares. Specifically, plaintiffs allege that defendants have caused the company to issue stock options in contravention of an equity incentive plan by setting the exercise price of the issued options at an unfairly low value. On March 24, 2008, defendants moved to dismiss this complaint under Rules 9(b), 12(b)(6), and 23.1. Defendants argue that the plaintiffs have failed to meet the heightened pleading requirements of fraud and demand futility and that the complaint otherwise fails to state a claim. Briefing on defendants' motion was completed on May 8, 2008. Although defendants have thrown nearly every rule in the book at plaintiffs' complaint in the hope of getting it dismissed, the complaint easily survives. For the reasons explained below in this Opinion, defendants' motion is denied.

I. FACTS

In 1996, plaintiffs London and Hunt, defendants Neven and Hupalo, and others founded MA Federal, Inc., which does business as iGov ("iGov" or the "Company"). iGov is a government contracting firm that initially focused on participating in the reseller market for information technology hardware, primarily selling to federal military and civilian agencies. After nine years in the low margin, highly competitive reseller market, however, the Company decided to

change its focus from product sales to the higher margin government services market. Consequently, since October 2005, iGov has competed for government services contracts, and has begun to reap the financial rewards of its shift in focus.

The facts pertinent to plaintiffs' claims occurred in 2006. At that time, iGov's board of directors consisted of London, Hunt, Neven, and Hupalo, and Tyrrell was the chief financial officer, having been brought to iGov by Neven the previous year. Plaintiffs allege that "[s]ometime in 2006, the Defendants secretly decided to implement an options plan at an unfair price to benefit themselves at the expense of the other stockholders."¹ To allow defendants to value the stock of iGov and thus set the price of options, defendants caused the Company to retain Chessicap Securities, Inc. ("Chessicap"). Plaintiffs do not allege the precise time by which Chessicap was retained, but they do allege that Chessicap's analysis valued the Company as of July 31, 2006. Despite the date of the valuation, Chessicap did not deliver its initial draft until late September 2006 and did not offer its final draft until later that year. iGov used the Chessicap valuation to set the price of the stock options granted in February and May 2007. Those options were granted pursuant to a plan that required the options' exercise price to be set with a value of at least 100% of the fair market value of the Company's stock as of the date of the grant.

¹ Compl. ¶ 26.

Plaintiffs cite two problems with the options granted by defendants to themselves and others. First, the valuation on which the price of the options was based was fundamentally flawed because Tyrrell provided misleading and incomplete information to Chessicap. Second, the options were granted in contravention of the stock option plan because the Chessicap report valued the Company as of July 2006 but the options were not granted until February and May 2007.

A. The Chessicap Valuation

Chessicap was not the only financial institution receiving projections and information from Tyrrell in 2006. During that year, iGov was looking for a lender to provide it with an approximately \$12 million line of credit. One of the potential lenders was Textron Financial (“Textron”). To induce Textron to provide the needed credit, Mr. Tyrrell kept Textron apprised of iGov’s financial condition—creating and approving the financial information transmitted, which included monthly income statements, balance sheets, and updated forecasts for fiscal years 2006 and 2007. Moreover, Tyrrell frequently wrote to Textron, consistently boasting of how well iGov was performing.

Specifically, Tyrrell sent Textron a 2007 forecast projecting an EBITDA of over \$3 million. That figure took into account the fact that iGov was likely to be awarded—but had not yet been awarded—a lucrative contract from the

Department of Homeland Security (“DHS”). Tyrrell also highlighted iGov’s future cost-cutting plans and predicted sustained profitability going forward. The complaint alleges that Textron granted the requested line of credit based on these assurances and projections.

Yet, the projections Tyrrell provided to Chessicap were markedly different. First, after receiving a draft of the Chessicap report that valued iGov at \$5.5 million, defendants sought to revise the data given to Chessicap because the \$5.5 million figure was “probably on the high side.”² Second, defendants excluded from the projections given to Chessicap any income from the DHS contract because that contract had not yet technically been awarded. Third, the defendants, in their revisions following the \$5.5 million valuation, made material changes to the 2007 forecast based on decisions that were made after the valuation date of July 31, 2006. For example, based on the announcement on October 4, 2006 that iGov was going to shut down a subsidiary, the revenue projection for this unit went from \$25,150,000 in the initial forecast to \$0 in the revised forecast. Mr. Tyrrell also revised the projected revenue for another unit from \$6 million to \$900,000 because he thought that unit might be closed by the end of November. Moreover, although the revised forecast took account of negative events that occurred after July 31, 2006, it did not reflect positive developments that occurred after the

² *Id.* at ¶ 28 (quoting an email from Tyrrell to Chessicap).

valuation date, such as the award of a \$7 million contract with the U.S. Patent and Trademark Office or the significant increase in profitability in another, preexisting contract. Moreover, in December 2006, DHS announced that iGov was the winning bidder for the contract, pending only the customary small business size protest period.

The revised forecast was allegedly never disclosed to Textron, and was allegedly never used by the Company in managing its business. Rather, plaintiffs allege, the revised forecast was purposely designed to suppress the value of the Company and only for use by Chessicap. Based on this revised forecast, Chessicap valued iGov at \$4.7 million as of July 31, 2006. Chessicap, of course, did not offer this valuation until late in the fall or winter of 2006. The Chessicap final report was provided to plaintiffs on or around December 29, 2006. Thereafter, London and Hunt asked to be provided with the financial information that Chessicap used to render its valuation. This information was provided on January 11, 2007, and five days later London objected to iGov's relying on the Chessicap report, stating that the valuation was stale. One day later, on January 17, 2007, Hunt offered to buy all of Neven's shares at \$28 per share and made clear that his offer applied to all shareholders. At the price offered by Hunt, iGov would be worth \$20 million. His offer, however, was summarily rejected.

Two days after Hunt made this offer and three days after London criticized the Chessiecap valuation, Neven and Hupalo caused plaintiffs to be removed from the Board through a written consent. They also elected Tyrrell to the board by written consent. Thus, as of January 19, 2007, the defendants comprised the entire board of iGov. The new board contacted Chessiecap about the Hunt offer of \$28 per share. Chessiecap responded by preparing an addendum—not by modifying its final report. In the addendum, Chessiecap stated simply that the Hunt “offer in no way affects or changes” the \$4.7 million valuation as of July 31, 2006, and concluded that the value of iGov’s common stock as of that July 31, 2006 valuation date was \$4.92 per share. However, this per share price was calculated by including 65,000 shares and 300,000 options that were not outstanding as of July 31, 2006.³

B. The Granting of the Options

On January 30, 2007, the defendants held a telephonic meeting of the board of directors and unanimously voted to adopt the 2007 Equity Incentive Plan. This plan provides, in part, that the exercise price of an option “shall be not less than one hundred percent (100%) of the Fair Market Value of the Common Stock

³ These shares and options were presumably contemplated at the time the addendum was prepared, but were not actually approved until after the addendum was issued, on January 30, 2007.

subject to the Option on the date the Option is granted.”⁴ For stockholders holding more than ten percent of iGov’s stock . . . the exercise price shall be “at least one hundred ten percent (110%) of the Fair Market Value of the Common Stock on the date of the grant.”⁵ The director defendants authorized themselves to submit this plan to the stockholders for approval within twelve months.

In addition to adopting the Equity Incentive Plan, the defendants also voted unanimously to approve a resolution adopting the \$4.92 per share price of the Chessicap report “to be appropriate for purposes of determining the fair market value of the Company’s Common Stock.”⁶ With the price set, the defendants then approved the grant of 300,000 options to sixteen employees pursuant to the Equity Incentive Plan. Among those 300,000 options were 80,000 for Tyrrell, 50,000 for Neven, and 50,000 for Hupalo. Finally, the defendants also authorized the sale of 65,000 additional shares to Tyrrell at the \$4.92 per share price. The options were granted and the sale to Tyrrell was consummated on February 1, 2007.

As iGov had long anticipated, DHS had all-but-announced in December, and Tyrrell had long promised to shareholders and Textron, iGov announced on March 7, 2007 that it was officially awarded the contract with DHS. The second quarter results for fiscal year 2007 were available in April 2007, and iGov showed an

⁴ Compl. ¶ 38 (emphasis removed).

⁵ *Id.*

⁶ *Id.* at ¶ 39.

operating income in excess of \$1.4 million. Between this and the DHS contract, it seemed clear that iGov would outperform its own projections for 2007. Despite this, however, the defendants granted 25,000 options to another employee on May 30, 2007 priced at \$4.92 per share. In their unanimous written consent authorizing the grant, the defendants justified using the \$4.92 per share price because they “concluded that [since February 1, 2007] there ha[d] been no material changes affecting [iGov’s] financial operations or prospects which would affect the [Chessiecap valuation opinion].”

II. STANDARD

Defendants have moved to dismiss the complaint pursuant to Rules 9(b), 12(b)(6), and 23.1. The standards governing such a motion are “familiar” to this Court.⁷ Under Rule 12(b)(6), a complaint may be dismissed where the plaintiff fails to state a claim upon which relief can be granted. In determining whether or not a complaint states such a claim, the Court must accept all well pleaded allegations as true and must draw all reasonable inferences in favor of the plaintiff.⁸ Of course, the Court neither heeds nor draws inferences from conclusory allegations.⁹

⁷ *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 889 (Del. Ch. 1999) (“In deciding the defendant’s motion to dismiss, I will apply the familiar standard.”).

⁸ *E.g.*, *Feldman v. Cutaia*, No. 466, 2007, slip op. at 7, 2008 WL 2223084, at *3 (Del. May 30, 2008).

⁹ *E.g.*, *White v. Panic*, 783 A.2d 543, 549 (Del. 2001); *see also In re Coca-Cola Enters., Inc.*, C.A. No. 1927-CC, 2007 WL 3122370, at *2 (Del. Ch. Oct. 17, 2007) (“An allegation is

Those general precepts of motions under Rule 12(b)(6) are augmented by Rules 9(b) and 23.1, which require particularized pleading where a complaint asserts allegations of fraud or derivative claims, respectively. This standard of particularity represents “a marked departure from the ‘notice’ pleading philosophy”¹⁰ of Rule 8 and makes pleading under Rules 9(b) and 23.1 “more onerous.”¹¹ Nevertheless, the burden remains on the movant to demonstrate that the plaintiff has not met the requirements of Rules 9(b), 12(b)(6), and 23.1.¹²

III. DEMAND FUTILITY

Defendants’ primary argument charges that plaintiffs failed to make a demand on the board of directors and failed to adequately plead why demand would be futile. Rule 23.1 requires plaintiffs in a derivative suit to “allege with particularity the efforts, if any, made by plaintiff to obtain the action the plaintiff desires from the directors . . . [or] the reasons . . . for not making the effort.”¹³ The purpose of the demand requirement has been explained elsewhere,¹⁴ and where, as here, the plaintiff alleges that demand would have been futile, the Court proceeds

conclusory when it merely states a generalized conclusion with no supporting facts.”), *aff’d sub nom. Int’l Bhd. of Teamsters v. The Coca-Cola Co.*, No. 601, 2007 (Del. June 20, 2008).

¹⁰ *Allison ex rel. Gen. Motors Corp. v. Gen. Motors Corp.*, 604 F. Supp. 1106, 1112 (D. Del. 1985), *aff’d*, 782 F.2d 1026 (3d Cir. 1985) (TABLE).

¹¹ *Levine v. Smith*, 591 A.2d 194, 207 (Del. 1991), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

¹² *See Fisk Ventures, LLC v. Segal*, C.A. No. 3017-CC, 2008 WL 1961156, at *8 (Del. Ch. May 7, 2008).

¹³ Ct. Ch. R. 23.1(a).

¹⁴ *See, e.g., Khanna v. McMinn*, C.A. No. 20545-NC, 2006 WL 1388744, at *11 n.50 (Del. Ch. May 9, 2006).

under the analysis of one of two decisions: *Aronson v. Lewis*¹⁵ or *Rales v. Blasband*.¹⁶ Because the complaint here challenges a decision made by the current board of directors of the corporation on whose behalf the suit was filed, the *Aronson* test applies.¹⁷ Under *Aronson*, a plaintiff demonstrates demand futility when “a reasonable doubt is created that: (1) the directors are disinterested and independent; or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.”¹⁸ Here, plaintiffs have satisfied demand futility under both prongs.

A. A Majority of the Board Was Interested in the Challenged Transactions

Under the first prong of *Aronson*, demand will be excused where the plaintiff has alleged facts that create a reasonable doubt that a majority of the directors were disinterested.¹⁹ The Court has explained that there are two ways a director can be deemed “interested” in a transaction. The first occurs where a director received in the challenged transaction a benefit that was not generally shared with the other shareholders of the corporation and where that benefit is “of

¹⁵ 473 A.2d 805 (Del. 1984).

¹⁶ 634 A.2d 927 (Del. 1993).

¹⁷ See *In re Bally's Grand Deriv. Litig.*, C.A. No. 14644, 1997 WL 305803, at *3 (Del. Ch. June 4, 1997) (noting that the *Rales* test applies only “(1) where a business decision was made by the board of a company, but a majority of the directors making the decision have been replaced; (2) where the subject of the derivative suit is not a business decision of the board; [or] (3) where ... the decision being challenged was made by the board of a different corporation.”).

¹⁸ *Postorivo v. AG Paintball Holdings, Inc.*, C.A. Nos. 2991-VCP, 3111-VCP, 2008 WL 553205, at *5 (Del. Ch. Feb. 29, 2008).

¹⁹ *Aronson*, 473 A.2d at 814–15.

such subjective material significance to that particular director that it is reasonable to question whether that director objectively considered the advisability of the challenged transaction to the corporation and its shareholders.”²⁰ The second occurs where “a director stands on both sides of the challenged transaction.”²¹ In that latter instance, the plaintiff need not show that the director received some sort of material benefit.²²

Defendants argue that plaintiffs have failed to satisfy the requirements of the first prong of *Aronson* because the complaint does not allege particularized facts that the options constituted a material benefit to each individual director defendant. This argument, however, ignores well settled law. Over ten years ago, in *Byrne v. Lord*, this Court held that “[b]y alleging that each of the members of the Pace board has a financial interest in the challenged option plan, Plaintiffs have alleged facts that create a reasonable doubt as to whether the Pace board is independent and disinterested.”²³ Similarly, in *Lewis v. Vogelstein*, former Chancellor Allen noted that directors who will receive stock options under a challenged transaction are interested in that transaction and ordinarily will have to prove its entire fairness.²⁴ Finally, Vice Chancellor Lamb held earlier this year that “demand will be excused [where] all five directors to consider demand received at least some of

²⁰ *Orman v. Cullman*, 794 A.2d 2, 25 n.50 (Del. Ch. 2002).

²¹ *Id.*

²² *Id.*

²³ C.A. Nos. 14040, 14215, 1995 WL 684868, at *4 (Del. Ch. Nov. 9, 1995).

²⁴ 699 A.2d 327, 333 (Del. Ch. 1997).

the challenged option grants” because those directors “are not disinterested.”²⁵ None of those cases requires a showing that the options received by the director defendants constituted material benefits. Although the general rule holds that “demand is not excused simply because directors receive compensation from the company or an executive of the company,”²⁶ the receipt of stock options is different. Directors who have received the options plaintiffs seek to challenge “have a strong financial incentive to maintain the status quo by not authorizing any corrective action that would devalue their current holdings or cause them to disgorge improperly obtained profits.”²⁷ In sum, the defendants here stood on both sides of the transaction that plaintiffs are challenging; the defendants both granted and received the stock options. Demand is, therefore, excused under the first prong of *Aronson*.

B. There is a Reasonable Doubt that the Challenged Transaction Was an Exercise of Valid Business Judgment

In addition, the complaint contains sufficiently particularized allegations of fact to satisfy the second prong of *Aronson*. As the Court noted in *Weiss v. Swanson*, “[a]lthough . . . compensation decisions are typically protected by the business judgment rule, the rule applies to the directors’ grant of options pursuant to a stockholder-approved plan only when the terms of the plan at issue are

²⁵ *Weiss v. Swanson*, C.A. No. 2828-VCL, 2008 WL 2267020, at *9 (Del. Ch. Mar. 7, 2008).

²⁶ *Id.*

²⁷ *Conrad v. Black*, 940 A.2d 28, 38 (Del. Ch. 2007).

adhered to.”²⁸ The Court explained that this conclusion was compelled by its holding in *In re Tyson Foods, Inc. Consolidated Shareholder Litigation*,²⁹ where the Court made clear that “allegations in a complaint rebut the business judgment rule where they support an inference that the directors intended to violate the terms of stockholder-approved option plans.”³⁰

Here, the Equity Incentive Plan under which the challenged options were granted requires that the exercise price of options be set at 100% or 110% of the stock’s fair market value as of the date of the grant of the options. The complaint alleges particularized facts that lead to the reasonable inference that the defendants intentionally granted options in contravention of that fair market value requirement. It does so in two ways. First, the complaint alleges that the defendants intentionally gamed the Chessicap valuation by withholding positive information about the Company while freely supplying the negative. In fact, the complaint alleges, after the first draft pegged iGov’s value at \$5.5 million, Tyrrell sent Chessicap new numbers in order to depress the final valuation. Second, the complaint alleges that the directors intentionally violated the Equity Incentive Plan by pricing the options it granted in February and May of 2007 at the price Chessicap said was fair as of July 2006. Plaintiffs have alleged that defendants

²⁸ 2008 WL 2267020, at *4 (footnote omitted).

²⁹ 919 A.2d 563 (Del. Ch. 2007).

³⁰ *Weiss*, 2008 WL 2267020, at *4.

knew Chessicap was not provided with information of materially positive developments from the latter half of 2006 and, therefore, knew that the Chessicap valuation could not possibly represent the fair market value of the Company as of February and May 2007.

The particularized facts of the complaint support an inference that the directors knowingly violated the Equity Incentive Plan. Consequently, under *Weiss* and *Tyson*, plaintiffs have also satisfied demand futility under the second prong of *Aronson*, and for this alternative reason defendants' motion to dismiss under Rule 23.1 is denied. Because plaintiffs have satisfied demand futility under both prongs of *Aronson* and defeated defendants Rule 23.1 motion, they have alleged sufficient facts to state a claim, and defendants' motion under Rule 12(b)(6) is likewise denied.³¹

IV. FRAUD

Defendants have also moved to dismiss the complaint under Rule 9(b) because, they contend, plaintiffs have not alleged fraud with sufficient particularity. The basis of this argument is apparently two provisions of the General Corporation Law, 8 *Del. C.* §§ 152 and 157(b). Neither of these sections operates as defendants contend. First, defendants are simply wrong when they

³¹ See *In re Tyson Foods, Inc.*, 919 A.2d 563, 582 (Del. Ch. 2007) (noting that “the *Aronson* test for demand futility closely resembles the test for determining whether a duty of loyalty claim survives a motion to dismiss under Rule 12(b)(6)” and commenting that the pleading standards under Rule 23.1 are more stringent than under Rule 8).

state that section 157(b) “provides that defendants’ judgment is conclusive as to the consideration *and exercise price* of such options.”³² On the contrary, section 157(b) authorizes boards to create and issue rights or options and protects the board’s determination of appropriate “consideration for the *issuance* of such rights or options.” It says nothing about the directors’ judgment in valuing the stock to be sold pursuant to the rights or options or the resulting exercise price, which is the issue plaintiffs’ complaint raises.³³ Thus, section 157(b) is of no help to defendants.

Second, Section 152 provides for situations where stock is issued for consideration other than cash. It states that:

[t]he board of directors may authorize capital stock to be issued for consideration consisting of cash, any tangible or intangible property or any benefit to the corporation, or any combination thereof. In the absence of actual fraud in the transaction, the judgment of the directors as to the value of such consideration shall be conclusive.

As with section 157, the scope of section 152 was addressed many years ago by Chancellor Seitz. In *Bennett v. Breuil Petroleum Corp.*,³⁴ the Court held that “Section [152] deals with the judgment of the directors as to the value of property

³² Defs.’ Opening Br. at 2 (emphasis added).

³³ See *Bennett v. Breuil Petroleum Corp.*, 99 A.2d 236, 240 (Del. Ch. 1953) (“8 *Del. C.* § 157 is not pertinent to the question of the value placed on the shares themselves—the issue here. It applies to the value placed on the rights, apart from the stock itself—not the issue here.”); 1 EDWARD P. WELCH, ANDREW J. TUREZYN, AND ROBERT S. SAUNDERS, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 157.5 (5th ed. 2007 supp.) (“separate consideration is required for issuance of the option and for its exercise”).

³⁴ 99 A.2d 236 (Del. Ch. 1953).

received for stock. Our case involves the value of stock issued for cash.”³⁵ This conclusion was more recently confirmed by Vice Chancellor Strine, who explained that “Section 152 deals with a situation in which the directors of a corporation have accepted *non-cash consideration* in exchange for company stock, and there is a dispute raised about whether the non-cash consideration was worth what the directors said it was.”³⁶ Moreover, Vice Chancellor Strine noted, even if section 152 did apply, defendants would still not be correct in suggesting that plaintiffs need to plead the elements of common law fraud because the concept of “actual fraud” is different.³⁷ Defendants’ briefs ignore law that has been established by this Court for over half a century. Consequently, defendants have failed to meet their burden on their motion to dismiss under Rule 9(b), because plaintiffs had no requirement to plead the elements of fraud with particularity in order to state a claim in this case.

³⁵ *Id.* at 240.

³⁶ *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1233 (Del. Ch. 2001) (emphasis added), *rev’d on other grounds*, 817 A.2d 149 (Del. 2002).

³⁷ *See id.* at 1234–35 (“Even if § 152 did apply, it is not apparent that the pleading of additional counts of constructive and actual fraud would help it out. Our courts have been relatively flexible in implementing § 152’s ‘actual fraud’ requirement, and for good reason. The term seems to have little to do with common law fraud . . . The concept of actual fraud under § 152 has to be read in the context in which it is used. When corporate directors allow the corporation to accept bananas they know to be worth \$10,000 on the open market from a majority stockholder in exchange for \$100,000 worth of corporate stock, they have in colloquial terms committed a ‘fraud on the corporation’ they are entrusted to manage.” (footnotes omitted)).

V. CONCLUSION

For the reasons explained above, the complaint adequately pleads demand futility with particularity, does not need to plead the elements of fraud with particularity, and does indeed state a claim. As a result, defendants' motion to dismiss is denied.

IT IS SO ORDERED.