IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

DAVID McILQUHAM, LEE WYATT, MARK WOZNIAK,	)	
Plaintiffs/Counterclaim Defendants,	)	
v.	)	C.A. No. 19042
GREGORY L. FESTE,	)	
Defendant/Counterclaim Plaintiff and Third-Party Plaintiff,	)	
v.	)	
MATTRESS HOLDINGS INTERNATIONAL, LLC,	)	
Third-Party Defendant/Counter-claimant and Fourth-Party Plaintiff,	)	
v.	)	
MALACHI MATTRESS AMERICA, INC.,	)	
Fourth-Party Defendant.	)	

MEMORANDUM OPINION

SUBMITTED: January 4, 2002
DECIDED: February 13, 2002

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LAMB, Vice Chancellor.

Three of the four remaining directors of a Delaware corporation with a seven person board acted at a meeting of directors to appoint three persons to fill the vacancies. Because the fourth director contested the validity of that action, the three directors brought this Section 225 action seeking a declaration that they acted properly in filling the vacancies. The principle issue presented is whether or not a stockholders agreement, to which all of the stockholders and the corporation were parties, vests in the fourth director and stockholders he claims to represent exclusively the power to fill those three vacancies. For the reasons that follow, I find that it does not, and thus conclude that the act of a majority of the remaining directors to fill the vacancies was validly taken.

I.

Plaintiffs David McIlquham, E. Lee Wyatt, Jr. and Mark Wozniak and defendant Gregory Feste are members of the board of directors of Malachi Mattress America, Inc. ("MMA"), a Delaware corporation. Feste currently owns approximately 10% of MMA's outstanding common shares and controls an additional 29% of the shares through various proxies and voting agreements.

McIlquham, Wyatt and Wozniak are associated with Sealy Corporation ("Sealy"), a national manufacturer and distributor of mattresses and related products. Through Mattress Holdings International, LLC ("MHI"), a Delaware limited liability company, and other affiliates, Sealy owns between 49% and 51% of MMA's common stock.

MMA is engaged in the retail sale of mattresses and frames through approximately 300 company-owned and franchise stores. MMA does business under the name "Mattress Firm." MMA was formed in February 1999 by Feste and a group of investors who operated franchisee Mattress Firm stores in connection with a plan to acquire Mattress Ventures, Inc., which was both the franchiser and itself the operator of a number of other Mattress Firm stores.

Feste is a businessman with experience in private equity and other varieties of investment transactions. Through his own company, Feste provides investment advisory services and engages in private equity ventures for himself and his clients. Prior to negotiating the MMA transaction with Mattress Ventures and Sealy, Feste had negotiated and closed a series of transactions in which he and his clients obtained rights to operate Mattress Ventures franchise stores in Tennessee, Florida, and

Texas. Feste was represented in his dealings with Sealy and Mattress Ventures by an attorney, Michael Noonan. Noonan had also represented Feste's interests in the earlier acquisitions of Mattress Ventures franchises. Feste continues to utilize Noonan's legal services.

At the time Feste approached Mattress Ventures, there was already a close business relationship between Sealy, which supplied the only branded mattress products in Mattress Firm stores, and Mattress Ventures. In late 1996 or early 1997, Sealy and Mattress Ventures entered into an agreement whereby Sealy loaned Mattress Ventures money to support new store openings. As a part of that agreement, Sealy obtained an option to purchase 25% of Mattress Ventures in the event the Mattress Ventures owners sold a controlling interest to someone else.

Early in 1999, Feste was in negotiations with the owners of Mattress Ventures about a plan to roll up all of the Mattress Firm franchisees controlled by Feste and his clients and then merge the resulting entity with Mattress Ventures. When he learned of the 25 % option held by Sealy, Feste contacted Sealy to explore involving it in the transaction. Negotiations extended from at least February 1999 through June 1999. Feste first met with representatives of Sealy at the Houston International

Airport in early 1999. The parties met again in late February or early March of 1999 in High Point, North Carolina for further negotiations.

After the High Point meeting, the parties turned to negotiating a letter of intent, which was signed in April 1999. Thereafter, the parties negotiated the form and content of the final deal documents, and the transaction closed at the end of June 1999. During the course of these negotiations, the parties exchanged at least nine drafts of the document that would, in its final form, be the Amended and Restated Stockholders Agreement (the "Stockholders Agreement" or "Agreement") that is at the center of this case. Both sides focused on, and successfully obtained revisions to, the language of Section 2(a)(ii), the provision that pertains to the designation of certain members of MMA's board of directors. From Feste's side, the work on the documentation was handled by Noonan, in consultation with Feste and Christopher Herndon, the then-President of MMA.

During the negotiations, Feste insisted that he "controlled the deal" and that Sealy would not be allowed to buy more than 49% of MMA's common stock and would. have contractual rights to control MMA only in limited, defined circumstances tied to a failure to meet set financial goals.

Sealy's representatives understood Feste to mean that Feste and all the other investors would act as a cohesive voting bloc under Feste's control. Sealy had no reason to question this understanding, which was reinforced by the pattern of the negotiations during which no person other than Feste or his representatives took part in negotiating any of the terms of the transaction or the deal documents with Sealy.

Sealy agreed to purchase 45% of the stock of MMA with the remaining 55 % of the stock to be owned by Feste and the other investors (collectively, "Existing Shareholders"). These percentages were later changed to 49% (Sealy) and 51% (Existing Shareholders) when Feste asked Sealy to put more money into the deal.

Neither Feste nor any of the other Existing Shareholders ever raised with anyone at Sealy the subject of structuring a contractual provision giving Feste or the Existing Shareholders, as a group, an express contractual right to control a majority of the MMA board. In fact, the only discussion regarding board control that Feste had was a discussion with Ron Jones, Sealy's CEO and Chairman of the Board, at a "break-out" session in High Point. Feste testified that he made clear to Jones that "we were going to own'a majority of this company and control the board." He

does not claim to have said anything about expecting or seeking a contractual right to appoint a majority of the MMA board. In addition, Feste admits that, between the High Point meeting and the closing, he gave no thought to the subject of stockholder meetings or votes. This is all consistent with the testimony of Jones that he never discussed with Feste how members of the MMA board would be selected or appointed and that he never agreed that Sealy or MHI would relinquish any voting rights as a stockholder in MMA.

Because MHI expected to be a minority stockholder in MMA, MHI negotiated for and obtained certain minority protections including a right to designate board representation proportionate to its share ownership. These matters were covered in both the Letter of Intent and the Stockholders Agreement. Feste and his colleagues never asked for parallel contractual rights to designate directors. Nor did Feste's representatives ever indicate during the negotiations that they thought the Existing Shareholders would have a parallel contractual right under the Stockholders Agreement.

On or about June 22, 1999, MMA, MHI and the Existing Shareholders entered into a Stock Purchase Agreement pursuant to which MHI agreed to purchase approximately 49% of MMA's common stock.

The same parties also entered into the Stockholders Agreement, dated as of June 28, 1999. The Stockholders Agreement is a fully integrated contract, by its terms.

The Stockholders Agreement gives MHI[1] the right to "designate" a number of members of the MMA board proportionate to the MHI's percentage ownership of MMA's common stock. Initially, MHI received the right to designate three of the seven person board. The Stockholders Agreement contains no parallel provision expressly empowering any other stockholder with a right to designate any member of the MMA board.

Section 2(a) of the Stockholders Agreement sets forth the parties' rights and obligations as they pertain to the election and replacement of directors. Section 2(a)(ii) states that:

> Holders of record of a majority of the MHI Shares entitled to vote for Directors of the Board will designate the number of Directors which is proportionate to the number of voting securities held by the MHI Investors; provided, that the MHI Investors shall initially designate three of the Directors of the Board . . . .[2]

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[1] The Agreement actually refers to "MHI Investors," defined as "any of MHI or any of its Permitted Transferees."

[2] Pl. Ex. 1 § 2(a)(ii) (emphasis in original).

There is no parallel provision defining the process for designating or electing the rest of the board of directors.

Section 2(a)(vi) of the Stockholders Agreement guarantees that MHI would be entitled to fill vacancies if one or more director designated by it resigned. That section provides, as follows:

> [I]n the event that any Director designated hereunder for any reason ceases to serve as a member of the Board during such Director's term of office, the resulting vacancy on the Board shall be filled by a Director designated by the Stockholders referred to in clauses (ii), (iii) and (iv) above.[3]

Although the term "Stockholder" is broadly defined in the Stockholders Agreement to include Existing Shareholders, nothing in the referenced clauses (ii), (iii), or (iv) provides for the designation of any director by any person other than MHI. The Agreement also does not contain any language limiting MHI's right to vote its shares with respect to the election of board members that are not designated by it. Moreover, there is no evidence that any such limitation was ever requested by Feste or anyone else representing the Existing Shareholders during the negotiations.

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[3] Pl. Ex. 1 § 2(a)(vi).

As part of the pre-closing negotiations, both sides agreed that the three initial MHI designees would be Wyatt, McIlquham and Ken Walker (who was later replaced by Wozniak) and that the other four initial board members would be Feste, Herndon, Joe Liebsack and Paul Stork. When Sealy's in-house counsel inquired about convening a shareholders meeting, Noonan suggested that it would be more convenient for the existing board to expand the size of the MMA board and fill the newly created vacancies with the persons already agreed upon by both sides.

In order to record the expansion and recomposition of the MMA board of directors, Noonan prepared two documents he labeled as "Minutes of the Meeting of the Board of Directors of MMA," dated June 24, 1999 and June 28, 1999, respectively. The record is now clear that no meeting was held on either date and that the "minutes," which are signed by the three directors then in office, functioned as unanimous written consents of the board. The documents purport to reflect statements made at such "meeting" that:

> In accordance with Section 2A(i)(ii) of the Stockholders Agreement, the Existing Shareholders shall have the right to designate four (4) of the Directors of the Board and MHI

> Investors (as defined in the Stockholders Agreement) shall have the right to designate three (3) Directors of the Board.[4]

The documents then reflect the resolution of the board to increase the number of directors from three to seven, and to appoint Feste, Herndon, Liebsack, Stork, Walker, Wyatt and McIlquham to serve as directors.

There is no evidence that MHI's attorneys at Kirkland & Ellis or anyone at Sealy, Bain or MHI ever read the purported minutes before the closing. Moreover, Noonan never told MHI or its lawyers, at any time, that the Existing Shareholders claimed a contractual right to designate directors. [5]

After the closing, Noonan prepared a summary of the terms and provisions of the Stockholders Agreement. His summary notes that MHI Investors have the right to designate directors but does not mention any correlative right on the part of non-MHI stockholders. Moreover, in early 2001 (before the controversy that is the subject of this case arose), Noonan circulated a proposed amendment to the Stockholders Agreement which

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[4] (emphasis added).

[5] Kirkland & Ellis' closing binder for the transaction (prepared after the closing by a legal assistant) does contain a copy of the "minutes." But Agrawal testified that he has no recollection of seeing or paying any attention to any board minutes before the closing.

would have inserted new language in Section 2 giving the non-MHI stockholders the right to designate members of the MMA board.

Between January 25, 2001 and March 28,200 1, Herndon, Stork and Liebsack-three of the four directors selected by Feste-all resigned from MMA's board. Feste initially alleged that Herndon's resignation had never become effective but dropped that contention before trial. On July 30, 2001, the three plaintiffs—McIlquham, Wyatt, and Wozniak-attended a meeting of the MMA board and voted to appoint David Campbell, Ken Southerland and Liebsack to fill the three open board seats. [6] None of these persons are associated with MHI or Sealy .

Feste received notice of the July 30th meeting but chose not to attend. Plaintiffs filed this Section 225 action on August 7, 200 1, seeking a determination that actions taken to appoint directors at a July 30, 2001 meeting were valid. In a November 16, 2001 memorandum opinion, I denied cross-motions for summary judgment.

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[6] Campbell and Liebsack later resigned, but Southerland continues to serve.

II.

The purpose of a Section 225 action is to provide a quick method for review of the corporate election process to prevent a Delaware corporation from being immobilized by controversies about whether a given officer or director is properly holding office.[7] In this case, plaintiffs contend that the clear and unambiguous language of the Stockholders Agreement confers no right upon the majority of the Existing Shareholders to designate and appoint members of the MMA board. Defendant Feste, however, contends that such a majority has a contractual right under the Stockholders Agreement to appoint a majority of those members.

Feste argues that the Stockholders Agreement must be interpreted in light of the purported "Minutes of the Meeting of the Board of Directors of MMA" dated June 24, 1999 and June 28, 1999. Feste also argues that the conduct of the parties during the negotiations and after the signing of the Stockholders Agreement demonstrates that they intended and agreed to allow the majority of non-MHI stockholders to appoint a majority of the members of the MMA board of directors.

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[7] *Box v. Box, 697* A.2d 395 (Del. 1997).

In the November 16, 200 1 decision denying summary judgment, I described the issue in the case as follows: "Whether the Stockholders Agreement reflects an agreement to regulate fully the power of the stockholders to elect directors or, instead, is limited to the protection of MHI from the potential majority voting power of the Existing Shareholders. "[8] My decision to deny summary judgment in favor of MHI reflected an inability "to determine conclusively that there [were] not material issues of fact related to both (i) the proper construction of the Stockholders Agreement, and (ii) the claim of unilateral mistake by Feste and his counsel. "[9]

Having now heard the testimony at trial and reviewed the evidentiary record, I am satisfied that the Stockholders Agreement does not and was never intended to reflect any agreement "to regulate fully the power of stockholders to elect directors. " Rather, it was negotiated for the purpose of according certain limited protections to MHI, the putative minority investor in the deal. Feste and his lawyer never asked for and never obtained correlative contract rights.

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[8] Nov. 16, 2001 mem. op. at 15.

[9] *Id.*

Under Delaware law, where a contract is plain and clear on its face, the writing itself is the sole source for gaining an understanding of intent. [10] Where no ambiguity is present, as I find to be the case here, the Court will not resort to extrinsic evidence in order to aid in interpretation, but will enforce the contract in accordance with the plain meaning of its terms. [11] A contract cannot be considered ambiguous unless "the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings. "[12] Because the Shareholders Agreement is not fairly susceptible to different meanings with respect to the appointment of directors, it cannot be considered ambiguous for the purposes of this case. Moreover, "[m]erely because the thoughts of party litigants may differ relating to the meaning of stated language does not in itself establish in a legal sense that the language is ambiguous. "[13] Where, as here, a written agreement is a fully integrated document, it generally

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[10] *Citadel Holding Corp. v. Roven, 603* A.2d 818, 822 (Del. 1992); *City Investing Co. Liquidating Trust v. Continental Casualty Co., 624* A.2d 1191, 1198 (Del. 1993).

[11] *City Investing, 624* A.2d at 1198.

[12] *Rhone-Poulenc Basic Chemicals Co. v. American Motorists Ins. Co., 6 16* A.2d 1192, 1196 (Del. 1992).

[13] *Standard Power & Light Corp. v. Investment Associates, Inc., 5* 1 A.2d 572, 576 (Del. 1947).

cannot be altered by parol evidence later submitted by one of the contracting parties. [14]

It is also important to bear in mind that one seeking to limit another's basic shareholder rights bears a heavy burden to establish that such a limitation exists or should be implied in contract. The right of stockholders to elect directors is a fundamental component of stockholder authority. [15] Although parties can contract to vary those rights, such variations will only be recognized and enforced if they are clearly and unambiguously expressed in a written contract. [16] Thus, since Feste alleged that MHI has no right to vote its shares for the election of a majority of the board seats, he could not prevail unless he succeeded in showing that such a limitation clearly and unambiguously exists or otherwise should be

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[14] ***Auerbach v. Earth Energy Systems, Inc.,*** **1988 Del. Ch. LEXIS 58 at *10 (Del. Ch.).**

[15] ***Rohe v Reliance Trading Network, Inc.,*** **2000 Del. Ch. LEXIS 108 at *37 (Del. Ch.).**

[16] ***Id. See also Rainbow Navigation, Inc. v. Yonge, 1989*** **Del. Ch. LEXIS 41 at *12 (Del. Ch.).**

implied from or inserted into the Stockholders Agreement. Feste completely failed to meet this burden at trial. [17]

Section 2(a) of the Stockholders Agreement is the only provision in the Agreement that references the parties' rights and obligations as they pertain to the election and replacement of directors. Section 2(a) grants MHI the right to designate directors in proportion to its ownership stake in the voting shares of the company. There are no parallel rights of designation for Existing Shareholders found in Section 2(a) or anywhere else in the Stockholders Agreement.

Feste argues that because the term "Stockholders" is broadly defined in the Agreement, [18] references to "Stockholders" in Sections 2(a)(v), (vi) and 2(c) of the Agreement must mean that both MHI and the Existing Shareholders have rights to designate directors and replacements. This

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[17] The record demonstrates amply that language contained in Section 2 of the Stockholders Agreement regarding the appointment of board members was intensely negotiated between the two sides. Yet, Feste never asked for a contractual right to appoint anyone to the MMA board. During the negotiations, there was also no discussion of restricting the right of MHI to vote its shares as to those board members who were not designated by MHI. According to the deposition testimony of both Wyatt and Jones, neither ever understood the Stockholders Agreement to restrict any rights of MHI to vote their shares with respect to the remaining board members.

[18] The Agreement defines "Stockholders" to include the MHI investors and non-MHI investors collectively.

argument fails as a matter of contract construction and also because there is no evidence in the record that Feste or Noonan ever even proposed the inclusion of such a provision in the contract. First, as a matter of construction, the contract provisions Feste relies on do not support the broad reading he suggests. Thus, for example, Section 2(a)(vi) reads:

> [I]n the event that any Director designated hereunder for any reason ceases to serve as a member of the Board during such Director's term of office, the resulting vacancy on the Board shall be filled by a Director designated by the Stockholders referred to in clauses (ii), (iii) or (iv) above. [19]

But, the only directors designated pursuant to clauses (ii), (iii), or (iv) of Section 2 are directors designated by the MHI Investors. Because MHI is the only stockholder with the right to designate directors pursuant to "clauses (ii), (iii) or (iv), " there is no room to read the reference to "Stockholders" more broadly in order to imply some power not expressly provided for.[20] It should also be noted that none of these provisions in any way restricts MHI from exercising voting power in connection with the election or replacement of directors not designated by it.

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[19] Pl. Ex. 1 § 2(a)(iv).

[20] The use of the term "Stockholders" in clauses (ii), (iii), and (iv) is explained by the fact that Agrawal prepared the first draft of the Stockholders Agreement by using a computer-based template that was drawn to allow for the possibility that the parties would include reciprocal rights in Section 2(a)(i).

Second, Feste's own legal counsel, Noonan, who negotiated the language of the Stockholders Agreement, admits that it does not contain language expressly providing that a majority of the Existing Shareholders have a right to designate a majority of the directors.[21] Noonan further acknowledged that the Stockholders Agreement does not contain any explicit limitation on the right of MHI to vote shares with respect to the election of directors in general."

Because the Stockholders Agreement is not reasonably or fairly susceptible to differing interpretations as to whether a majority of Existing Shareholders may appoint a majority of the board of MMA, Feste may not introduce extrinsic evidence "to interpret the intent of the parties, to vary the terms of the contract or to create an ambiguity. "[23] Even if this were not so, Feste failed to adduce at trial evidence showing either that (i) the parties ever agreed to commit themselves contractually to the terms Feste now claims, (ii) Feste or Noonan reasonably believed that the Stockholders Agreement contained a contractual term giving the Existing Shareholders

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[21] Noonan Dep. Desig. at 179: 13-18.

[22] Noonan Dep. Desig. at 166: 5-19.

[23] *Eagle Indus. v. DeVilbiss Health Care*, 702 A.2d 1228, 1232 (Del. 1997).

the right to designate directors, or (iii) MHI or its advisors were aware that Feste entertained such a patently unreasonable belief. Therefore, there is no basis to conclude that provisions such as those Feste now claims were part of the deal were somehow omitted from the Stockholders Agreement due to either mistake or fraud.

I specifically reject the contention that the "Minutes of the Meeting of the Board of MMA," dated June 24, 1999 and June 28, 1999, and prepared by Noonan, offer proof that the Stockholders Agreement gives the non-MHI stockholders a right to designate directors. Noonan himself confirmed, however, that no such "meeting" of the members of the board of directors occurred on either of those dates. Given the impossibility of a Sealy or MHI representative participating in a meeting that did not occur, these minutes do not show any knowledge or intent on the Sealy/MHI side of Feste's alleged misunderstanding regarding the meaning of Section 2 of the Agreement. At the summary judgment phase, the existence of these minutes indicated the possibility that, through the questioning of witnesses, such knowledge or intent might be shown at trial. That did not occur.

There simply is no evidence that anyone representing Sealy/MHI read or approved the purported minutes. The language of the Stockholders

Agreement had already been finalized by the time Noonan claims to have faxed the "minutes" to the New York office of Kirkland & Ellis on June 25, 1999. Agrawal, had no recollection of having seen the "minutes" or having remarked on their obvious misinterpretation of the Stockholders Agreement. Thus, the language of the minutes regarding the Existing Shareholders' power to "designate" directors does not serve as useful evidence for Feste or his position.

Finally, I am unable to agree that the court should focus on what the parties likely would have done in order to supply a "missing term" to the Agreement. But there is no evidence that the parties ever agreed-in writing or otherwise-that the non-MHI shareholders would have a right to designate any directors parallel to the right of MHI to designate directors. Nor is there evidence of any restriction on how MHI (or any directors it designates) could vote with respect to the election or appointment of directors not designated by MHI. Without such evidence, there is no basis for the Court to supply a missing term or to change the language chosen by the parties .[24]

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[24] *Cincinnati SMSA Ltd. Pshp. v. Cincinnati Bell Cellular Sys. Co.*, 708 A.2d 989, 992 (Del. 1998). The evidence also does not support Feste's assertions that MHI

III.

In sum, the Stockholders Agreement is clear and unambiguous in conferring only on MHI the right to designate members of the board of directors of MMA and provides no comparable right to Feste or any non-MHI stockholder. The Stockholders Agreement contains no language restricting the voting rights of MHI-or anyone else-with respect to voting for any board seat not subject to MHI's right to designate. Moreover, the record at trial makes clear that Feste had neither a contractual right nor the expectation of a contractual right for parallel designation power to that of MHI/Sealy.

For all these reasons, I conclude that the action taken at the July 30, 2001 meeting to appoint Campbell, Liebsack, and Southerland to fill vacancies was validly taken. Feste's later purported designation (on behalf of a majority of the Existing Shareholders) of Herndon, Gaylon Boyd and Gerrell Baird to the board was invalid. Although Campbell and Liebsack

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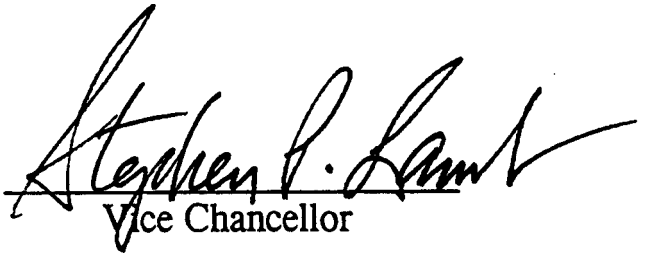
or plaintiffs engaged in conduct before or after the closing that would give rise to any equitable limit on their exercising their rights to elect directors and fill vacancies on the MMA board. Nor has Feste established either estoppel or unclean hands. Likewise, Feste offered nothing to support his arguments that the plaintiffs somehow violated MMA's Certificate of Incorporation, bylaws or Section 223 of the Delaware General Corporation Law, 8 *Del. C.* § *223.*

resigned after Feste disputed their appointments, Southerland remains a member of the MMA board. If a meeting of the MMA board is called by giving notice in accordance with the bylaws, a majority of the existing directors are free to fill the two current vacancies. Judgment shall be entered in favor of the plaintiffs and against the defendants on all claims and counterclaims. Costs to the plaintiffs. IT IS SO ORDERED.



Vice Chancellor