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Re: *Acker, et al. v. Transurgical, Inc., et al.*
Civil Action No. 201-N

Dear Counsel:

On March 19, 2004, David E. Acker and the David Ellis Acker 10-Year Grat Trust[1] filed an amended complaint asserting claims against Transurgical, Inc. ("TSI" or the "Company"), Reinhard J. Warnking, Alfred J. Novak, Damion Wicker, and Vincent Bucci. Defendants have moved to dismiss the amended complaint. For the reasons set forth below, the motion is granted in part and denied in part.

Background.[2] Acker is the founder and former CEO of TSI. He is still a minority shareholder of the Company. Defendants Warnking, Novak, Wicker, and Bucci were directors of TSI during the relevant periods. Warnking succeeded Acker as CEO in January 2001. Wicker is a managing director of J.P. Morgan

[1] For simplicity, I will refer to both plaintiffs as simply "Acker."
[2] The facts referenced are drawn from the complaint and documents integral to plaintiffs' claims and incorporated into the complaint.

Partners (SBIC), LLC ("JPM"). JPM, not a party to this action, is TSI's majority shareholder.

This action arises out of a change in TSI's capital structure in August 2003 (the "Recapitalization"). The Recapitalization was a multi-staged event that involved: (1) the issuance of a new series of stock; (2) the conversion of existing preferred stock into the newly issued stock; (3) the issuance of a second new series of stock; (4) the conversion of the new series of stock into the second new series of stock; (5) a reverse stock split; and (6) the reclassification of both new sets of stocks as preferred stock that is convertible to common stock.[3] The complaint alleges that the Recapitalization resulted in an unlawful transfer of wealth to JPM at the expense of Acker.[4] Specifically, Acker has enumerated eight counts of wrongdoing—ranging from breaches of fiduciary duty and contractual claims to out-and-out fraud. I address each count below.

Count I. In the first count, Acker alleges that the TSI board breached its fiduciary duty by approving the Recapitalization. According to Acker, the practical effect of the Recapitalization was an increase in the value of JPM's interest in TSI at the sole expense of Acker—causing Acker to suffer cash-value and voting power dilution. Acker seeks to recover from TSI's directors the benefit of increased ownership it gifted to JPM at his alleged expense.

Defendants argue that Count I only states a derivative claim and that Acker has failed under Court of Chancery Rule 23.1 either to make demand on TSI's board or to allege facts with particularity to support excusing demand. To determine whether a claim is direct or individual, "[i]n the context of a claim for breach of fiduciary duty, . . . the inquiry [is] as follows: 'Looking at the body of the complaint and considering the nature of the wrong alleged and the relief requested, has the plaintiff demonstrated that he or she can prevail without showing an injury to the corporation.'"[5] Acker has satisfied this inquiry.

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[3] *See* Am. Compl. ¶¶ 24-28.

[4] "Although JPM invested only approximately $4.5 million in the Company pursuant to the 2003 Recapitalization, the value of its investment in TSI jumped from approximately $26.74 million to approximately $45.3 million after it. On the other hand, the Acker Plaintiffs' approximately $17.5 million investment in TSI just before the 2003 Recapitalization was virtually wiped out by the transaction." Am. Compl. ¶ 13.

[5] *Tooley v. Donaldson, Lufkin, & Jenrette*, Del. Supr., No. 84, 2003, at 7-8, Veasey, C.J. (April 2, 2004) (quoting *Agostino v. Hicks*, 2004 WL 443987, at *7 (Del. Ch. Mar 11, 2004) (Chandler, C.)). An inquiry into "who would receive the benefit of any recovery or other remedy (the

The wrong alleged is that TSI's board reorganized the Company's capital structure to the benefit of JPM and to the detriment of Acker. In other words, the value of JPM's investment in TSI has allegedly been artificially inflated at Acker's expense. There is no allegation that the movement of capital from Acker to JPM harmed TSI. The absence of such an allegation is logical, as the defendants' movement of capital from one pocket (Acker's) to another (JPM's) does not imply that the value of TSI has declined. Even if one were to argue that the issuance of a new series of stock to JPM for less than fair value harmed TSI, the subsequent conversion of TSI's preferred shares and the shares newly issued into yet another new and distinct class of shares effectively took stock from Acker for less than fair value–resulting in a net wash from the Company's perspective.[6] In effect, TSI recouped any loss (to the benefit of the majority shareholder JPM) from Acker.[7] Since it appears from the body of the complaint that Acker can prove his harm without relying on proof of harm to TSI, this claim can proceed without the necessity of making a demand on TSI's board.

Count II. In this count, Acker alleges that TSI breached Section 7 of its Second Amended and Restated Stockholders Agreement and Section 4(e) of its Third Amended and Restated Certificate of Incorporation. Section 7 of the Stockholders Agreement obligates TSI to "'take all necessary and desirable actions within its control . . . so that . . . two representatives designated by David E. Acker . . . shall be elected to the Board and each committee thereof . . . .'"[8] Section 4(e) of the Certificate of Incorporation requires "a majority of the Corporation's directors who are not employees of the Corporation: . . . (iii) approve any annual budget . . . ."[9]

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corporation or the stockholders, individually?," *id* at 1, "should logically follow," *id*. at 8, from the primary inquiry.

[6] Most of JPM's pre-Recapitalization investment was in preferred stock and most of Acker's was in common stock. Part of the harm to Acker flows from an alleged bias between the two classes of stock. I think that the change in TSI's capital structure was unique in this respect, and I do not suggest that all recapitalizations would give rise to direct claims. An analogous set of facts was present in *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319 (Del. 1993), however, and a similar result was reached. *Id.* at 330.

[7] Defendants do not argue (and the complaint does not allege) that JPM would have invested more in TSI if the company had priced the new series of shares higher. JPM might not have invested at all.

[8] *See* Am. Compl. ¶ 54 (quoting § 7 of Stockholders Agreement).

[9] Defs.' Opening Br. in Supp. of Mot. to Dismiss the Am. Compl. ("OB"), Ex. D. I find this document integral to plaintiffs' claims and incorporated into the complaint.

Acker alleges that Section 4(e) of the Certificate of Incorporation was breached because (a) the Recapitalization was an "annual budget" and (b) a majority of non-employee directors did not approve the Recapitalization. Acker fails to state a claim, however, because a "budget" is "a plan or schedule of adjusting expenses during a certain period to the estimated or fixed income for that period."[10] A "recapitalization" is the change of a corporation's "capital structure."[11] An annual budget is distinct from a recapitalization and Section 4(e) does not govern the latter.[12]

Unlike the claim regarding the Certificate of Incorporation, I find that the complaint adequately states a claim regarding the purported breach of Section 7 of the Stockholders Agreement. Assuming the truth of the facts alleged in the complaint, it appears that TSI did not "take all necessary and desirable actions" to facilitate the election of "two representatives designated by David E. Acker."[13] Specifically, the complaint alleges that the Acker representatives were denied access to information necessary to fulfill their duties as directors of TSI and were forced out of the Company's boardroom.[14] Defendants' argument is that, even if Acker's board representatives had participated in the Recapitalization decision, the Recapitalization would have been adopted (as Acker's representatives constitute only a minority). The fact that Acker's representatives were in the minority prior to their alleged exclusion does not preclude a finding of harm.[15] Acker's representatives may have convinced the majority to abandon or modify the Recapitalization.

Counts III, IV, VI, and VII. Acker alleges that TSI, Wicker, and Warnking, "knew that TSI had fully-formed plans to recapitalize its capital structure in a manner that would cause the Acker plaintiffs to suffer cash-value

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[10] WEBSTER'S NEW WORLD COLLEGE DICTIONARY 182 (3d ed. 1997).
[11] *Id.* at 1119.
[12] This conclusion is buttressed by other provisions of the Certificate of Incorporation. *See* OB, Ex. D, at §§ 4(c)(i), (d)(ii).
[13] Am. Compl. ¶ 54 (quoting § 7 of Stockholders Agreement).
[14] *See* Am. Compl. ¶ 55.
[15] In *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003), the Supreme Court held that Liquid Audio's incumbent board of directors harmed MM Companies when it expanded the board from five to seven members, even though before and after the expansion MM was only entitled to two board nominees. *Id.* at 1132-33. "[D]iminishing the influence of MM's nominees," *id.* at 1126, was cognizable injury.

dilution of their shares of stock in TSI."[16] In Count III, Acker alleges that TSI, Wicker, and Warnking did not disclose this information to him when they induced Acker to assign his rights to certain patents over to TSI, thereby defrauding him of his interest in those patents. Count IV makes a similar claim, but it is styled as "negligent misrepresentation." Count VI is a fraud claim based on the same underlying conduct, but alleges that Acker was induced to sell some of his shares in TSI for below-market value. Count VII is the same as Count VI, but (like Count IV) is a claim for negligent misrepresentation.

Defendants challenge all of these counts on the ground that they fail to plead "the circumstances constituting fraud . . . with particularity."[17]

I find that Acker has met the pleading requirements of Rule 9(b). "The entire purpose of Rule 9(b) is to put the defendant on notice so that he can adequately prepare a defense."[18] Accordingly, Acker must plead "the time, place, and contents of the [omission], the identity of the person(s) making the [omission], and what he intended to obtain thereby."[19] "Malice, intent, knowledge and other condition of mind of a person may be averred generally."[20]

The complaint identifies with reasonable precision the time, place, and contents of the omission, the persons involved, and what those persons attempted to obtain.[21] The time was either August 21, 2001 or September 5, 2001. The place was a restaurant called Felidia. The content of the omission was a failure to inform Acker that TSI planned to almost completely eliminate his interest in the Company. The persons involved were Wicker and Warnking. Wicker and Warnking attempted to obtain Acker's patents by their omission and to induce him to sell his shares in the Company at below-market value.

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[16] Am. Compl. ¶ 61.
[17] CH. CT. R. 9(b).
[18] *Browne v. Robb*, 583 A.2d 949, 955 (Del. 1990).
[19] *H-M Wexford LLC v. Encorp, Inc.*, 832 A.2d 129, 145 (Del. Ch. 2003).
[20] CH. CT. R. 9(b).
[21] *See* Am. Compl. ¶¶ 61-63. Similar allegations are made in Counts IV, VI, and VII. *See* Am. Compl. ¶¶ 67-69, 75-78, and 82-83. The complaint also gives a complete factual recitation of a dinner at a restaurant called Felidia where allegedly the fraud was perpetrated. *See* Am. Compl. ¶¶ 43-44. Failure to disclose an existing plan is sufficient to establish an actionable omission under New York law. *See Buy This, Inc. v. MCI Worldcom Communications*, 209 F. Supp. 2d 334 (S.D.N.Y. 2002). Defendants argue and Acker does not dispute that New York law governs these counts. *See generally* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 188 (setting forth "most significant relationship" test).

Of most pressing concern to defendants is that "[t]here is simply no particularized allegation at all concerning the contention that Warnking and Wicker had a 'fully-formed plan,' as early as 2001, to virtually eliminate Acker's ownership stake in Transurgical."[22] There are two problems with this argument. First, this argument seems to go to the issue of Warnking and Wicker's knowledge. Knowledge may be averred "generally."[23] Second, defendants seem to be encouraging me to simply deny the truth of an allegation in the complaint. That I cannot do.[24]

Given that I have found Counts III, IV, VI, and VII meet the requirements of Rule 9(b), I need not consider Acker's argument that Rule 9(b) does not apply to claims for negligent misrepresentation.

Count V. In this count, Acker seeks a declaratory judgment that his patent assignments to TSI were void for lack of consideration. Defendants argue that the complaint, by its own terms, demonstrates there was consideration and that, independently, some of the assignments at issue were made outside the applicable statute of limitations.

The complaint alleges that Acker was a shareholder at all relevant times.[25] The complaint also alleges that the patents were assigned to TSI.[26] Defendants' argument is that "[t]he potential appreciation and return on Acker's shares, that could inure to Acker's benefit through Transurgical's use and ownership of the patents, is more than adequate consideration."[27] Acker's response is that the complaint, regardless of its other allegations, alleges that he did not receive any compensation or consideration for the patent assignments.[28] Therefore, Acker

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[22] Defs.' Reply Br. in Supp. of Mot. to Dismiss the Am. Compl., at 8.
[23] CH. CT. R. 9(b).
[24] *In re Walt Disney Co. Deriv. Litig.*, 825 A.2d 275, 285 (Del. Ch. 2003). It does not seem unreasonable to infer that Warnking and Wicker wanted to squeeze Acker out of TSI completely and that this was the "plan."
[25] Am. Compl. ¶¶ 1-2.
[26] *Id.* ¶ 45.
[27] OB, at 24. When evaluating consideration, "[i]t is enough that something is promised, done, forborne, or suffered by the party to whom the promise is made as consideration for the promise made to him." *Kinley Corp. v. Ancira*, 859 F. Supp. 652, 657 (W.D.N.Y. 1994) (*quoting Wiener v. McGraw-Hill, Inc.*, 57 N.Y.S.2d 193, 197 (N.Y. 1982)). Defendants argue and Acker does not dispute that New York law governs Count V.
[28] *See* Am. Compl. ¶ 72 (Acker "did not receive any consideration").

argues, defendants' position is inconsistent with the complaint and must be disregarded. Acker's contention is incorrect.

An allegation that a party has received no consideration is a conclusion of law and is not entitled to deference.[29] Further, the complaint pleads itself out of a viable claim that the assignments were without consideration. Defendants are not asking that the Court assume the falsity of a factual allegation in the complaint. To the contrary, defendants implore the Court to assume the truth of the allegations that (a) Acker was a shareholder of TSI and (b) Acker assigned the patents at issue to TSI. These allegations demonstrate the assignments were not without consideration.[30]

"[E]ven if the consideration exchanged is grossly unequal or of dubious value,"[31] the parties to a contract are free to make their bargain. "Absent fraud or unconscionability, the adequacy of consideration is not a proper subject for judicial scrutiny."[32] Any possible fraud or unconscionability claims are subsumed by Counts III and VI. Otherwise, Count V fails to state a claim.

Count VIII. The last count is styled as a breach of fiduciary duty of disclosure claim against Wicker and Warnking for failure to disclose the "fully-formed plan to recapitalize."[33] The defendants argue that disclosure of the Recapitalization in 2002 (or earlier) was not required because the information would have been inherently unreliable or speculative.[34] In support for their argument defendants cite to *Rosser v. New Valley Corp.*[35] In *Rosser*, then-Vice Chancellor Steele found that post-recapitalization price estimates for certain stocks and warrants were too speculative to be disclosed.[36] Specifically, *Rosser* stated:

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[29] 5A Charles Alan Wright & Author R. Miller, FEDERAL PRACTICE AND PROCEDURE 1357, at 311-21 (2d ed. 1990) (collecting cases).

[30] "If a plaintiff chooses to 'plead particulars, and they show he has no claim, then he is out of luck - he has pleaded himself out of court.'" *Jefferson v. Ambroz*, 90 F.3d 1291, 1296 (7th Cir. 1996) (quoting *Thomas v. Farley*, 31 F.3d 557, 558-59 (7th Cir. 1994)); *see also* 5A Wright & Miller, *supra* note 28, 1357, at 320.

[31] *Apfel v. Prudential-Bache Sec., Inc.*, 600 N.Y.S.2d 433, 435 (N.Y. 1993).

[32] *Id.*

[33] Am. Compl. ¶ 87.

[34] *See Arnold v. Soc'y for Sav. Bancorp., Inc.*, 650 A.2d 1270, 1280 (Del. 1994).

[35] 2000 Del. Ch. LEXIS 115 (Del. Ch. Aug. 15, 2000).

[36] *Id.* at *13.

"corporate management need not disclose ruminations regarding uncertain future value because their estimates could be as misleading as helpful."[37]

Contrary to defendants' argument, *Rosser* is of limited applicability here because Acker is not alleging that the *value* of his stock post-recapitalization should have been disclosed. Rather, Acker argues that the details of the Recapitalization itself should have been disclosed. Acker alleges that the details of the Recapitalization were already known to defendants and, therefore, were not speculative. More applicable to these facts is *Goldman v. Pogo.com, Inc.*[38] In *Goldman*, the Court refused to dismiss a fiduciary duty claim where the directors "failed to disclose fully the contemplated restructuring that result from the conversion of the various bridge loans" and the extent to which [the plaintiff's] equity position in the Company would likely be diluted."[39]

Ultimately, the issue raised by defendants is one of materiality, which is an inherently fact-sensitive inquiry not readily susceptible to dismissal.

Conclusion. Defendants' motion to dismiss is denied with respect to Counts I, III, IV, VI, VII, and VIII. Defendants' motion to dismiss is granted with respect to Count V. Defendants' motion to dismiss Count II is granted in part and denied in part.

IT IS SO ORDERED.

Very truly yours,

/S/ William B. Chandler III

William B. Chandler III

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[37] *Id.*
[38] 2002 Del. Ch. LEXIS 71 (Del. Ch. June 14, 2002).
[39] *Id.* at *37.