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Re: *Salamone v. Gorman*
C.A. No. 9870-VCN
Date Submitted: July 24, 2014

Dear Counsel:

This is the second 8 *Del. C.* § 225 action arising from the ongoing dispute over control of Westech Capital Corp. (“Westech”). The Court, in resolving the first Westech control dispute, interpreted a voting agreement binding the vote of Westech’s majority shareholder, John J. Gorman IV (“Gorman”).¹ The Court concluded that four directors had been validly elected in accordance with that

¹ See *In re Westech Capital Corp.*, 2014 WL 2211612 (Del. Ch. May 29, 2014). Cross-appeals of this decision are currently pending. The complications addressed by these Section 225 proceedings appear to result from a voting agreement signed by certain Westech investors which may have the effect of constraining Gorman from using his majority holdings to effectuate control over Westech. Defendants in that earlier proceeding did not move for a stay pending appeal. Perhaps this motion is in some way a substitute for that relief. Familiarity with the first proceeding is assumed.

voting agreement; that finding appears to have had the unfortunate result of creating deadlock on Westech's board. Gorman and a second director aligned with him were found to have been validly elected to the board and two incumbents, who oppose Gorman's influence over the company of which he is the majority shareholder, also remained on the board. Neither of these two incumbents is a Westech shareholder. These two sets of directors are opposing factions in this action.

Gorman's consent to the voting agreement has limited his ability to remove and replace the two incumbent directors, Gary L. Salamone ("Salamone") and Michael Dura ("Dura"). Salamone is also Westech's CEO and thus holds even greater influence over Westech's affairs. Salamone and Dura are refusing to attend board meetings and the description of counsel of the state of affairs at Westech creates a convincing portrait of deadlock. For example, former director Robert W. Halder ("Halder"), who was removed by the earlier Section 225 action, allegedly is employed by a competitor in contravention of a non-competition agreement with

Westech and the company is not enforcing its rights against him or otherwise preventing him from soliciting current Westech employees.²

Gorman, frustrated in part by this state of affairs, sought, through written shareholder consents, to amend Westech's bylaws to permit shareholders to remove officers of the corporation and to allow shareholders to replace those officers removed through shareholder action.³ Gorman next, also through written consent, purported to remove Salamone as CEO and to name himself as the replacement. He then designated a new director, Craig Biddle ("Biddle"), to the seat Gorman formerly held, thereby attempting to empower three friendly directors

² It is somewhat difficult to understand why what would seemingly be non-controversial actions, such as holding board meetings or preventing former employees from soliciting current employees away from Westech in contravention of an agreement with the company, have not been pursued by Westech's fiduciaries.

³ The amended bylaw provision reads:

Any officer may be removed, with or without cause, at any time by the Board or by the stockholders acting at an annual meeting or special meeting or acting by written consent pursuant to Section 2.8 of these Bylaws. The Board shall, if necessary, immediately implement any such removal of an officer by the stockholders. . . . Any vacancy occurring in any elected office of the Corporation may be filled by the Board except that any such vacancy occurring as a result of the removal of an officer by the stockholders shall be filled by the stockholders.

and obtain control over Westech's board.⁴ Plaintiffs, Salamone, Halder, and other shareholders and employees,⁵ have filed suit against Defendants Gorman and Biddle and request that the Court declare the bylaw invalid, enjoin Biddle from acting as a director, and instead declare that Salamone is Westech's CEO director. In the meantime, they have moved for the entry of a status quo order.

* * *

Status quo orders are often granted in control disputes of this type to preserve a corporation's affairs until a final judicial determination resolves the summary proceeding. The Court may enter a status quo order after a demonstration: "1) that the order will avoid imminent irreparable harm; 2) [of] a reasonable likelihood of success on the merits; and 3) that the harm to plaintiffs outweighs the harm to defendants."⁶ Plaintiffs have successfully made such a demonstration and a status quo order will be granted.

⁴ A variety of other accusations have been made by the parties, but with little corroboration in the record.

⁵ These employee shareholders are Michael Wolf, John Randolph, John Glade, James B. Rodgers, Matt Moran, Harry Friedberg, and William Clark.

⁶ *Raptor Sys., Inc. v. Shepard*, 1994 WL 512526, at *2 (Del. Ch. Sept. 12, 1994).

Westech and its shareholders would be irreparably harmed by the uncertainty concerning the composition of its legitimate board of directors.⁷ Defendants contend that no irreparable harm would occur if the status quo order were denied because Gorman is Westech's majority shareholder and he will disproportionately suffer the effects of the current deadlock. However, their argument overlooks the other investors in the enterprise. Defendants also assert that the incumbent members of the board are seeking to destroy company value in order to punish Gorman as Westech's majority shareholder. Such an argument essentially addresses the balancing of harms and is not an argument that no irreparable harm might occur.

Plaintiffs' other arguments relating to irreparable harm are speculative or unconvincing. Plaintiffs first argue that Gorman will loot Westech if he is granted influence over the company. Both factions accuse the other of being poor managers who may even have the affirmative goal of seeking to harm the

⁷ See *Frankino v. Nat'l Auto Credit, Inc.*, 1999 WL 959188, at *1 (Del. Ch. Sept. 28, 1999) (“[S]tatus quo orders identify the directors who shall manage the company as a means of reassuring shareholders and markets that someone has the legal right to manage the daily affairs of the company until the Court of Chancery resolves the § 225 action.”).

enterprise.⁸ However, on these facts, Gorman, as a majority shareholder, at least has a theoretical incentive to increase the value of the enterprise. Salamone and Dura, having no Westech equity, lack a similar incentive. Although the Plaintiff shareholder-employees may have some equity in Westech, their holdings are significantly less than Gorman's.

Plaintiffs' second argument is also speculative: they contend that Gorman "will likely destroy the Company's books and records in an effort to avoid regulatory and criminal sanctions for illegal securities trading."⁹ Such concerns may be dealt with in a number of ways without judicial intervention; perhaps one of the most readily-available solutions is that Westech could make copies of pertinent records and store them in a safe location before Gorman is granted

⁸ However, the factual record is not fully developed. Plaintiffs argue that Gorman is under investigation from a variety of regulatory agencies, although there is some suggestion that Plaintiffs prompted those investigations. In sum, the evidence of Gorman's intent to loot has not so far been persuasively established. Similarly, Gorman's claims about the other incumbents' waste are also unsubstantiated.

⁹ Pls.' Mot. for Entry of a Status Quo Order at 16.

inspection rights.¹⁰ Nonetheless, irreparable harm exists for the reason discussed above.

Defendants next argue that there is no reasonable likelihood of success on the merits because the bylaw which Gorman sought to implement, granting shareholders the power to remove and elect directors, is valid. They point out that bylaws are presumed to be valid¹¹ and contend that this bylaw is authorized by 8 *Del. C.* § 142(b), because that statute provides that “[o]fficers shall be chosen in such manner and shall hold their offices for such terms as are prescribed by the bylaws or determined by the board of directors or other governing body.”¹² They contend that 8 *Del. C.* § 142(b) does not infringe on the powers of a corporation’s board of directors because, although 8 *Del. C.* § 141(a) contemplates that the board of directors shall manage the business and affairs of every corporation, the statute

¹⁰ Alternatively, the location from which Gorman may inspect such records could be controlled or the records could be delivered to an attorney to hold the documents for Gorman’s review. Some combination of the above approaches could be utilized.

¹¹ *Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401, 407 (Del. 1985) (“The bylaws of a corporation are presumed to be valid, and the courts will construe the bylaws in a manner consistent with the law rather than strike down the bylaws.”).

¹² 8 *Del. C.* § 142(b).

also defers to other sections of Title 8 when it states “except as may be otherwise provided in this chapter or in its certificate of incorporation.”¹³

Defendants, however, recognize that tension exists between the shareholders’ franchise and the board’s managerial authority. They acknowledge that “[i]t is well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made.”¹⁴ Defendants argue that the bylaw at issue here only imposes procedural limits. They claim the bylaw does not “encroach upon, or even affect, the board’s managerial power.”¹⁵ They contend that the board still has the authority to elect and remove directors under the bylaw, as the bylaw did not take away those powers. They also argue that the board would still have the authority to manage, utilize, and direct the officers to carry out Westech’s business plans.

It would be premature, and perhaps unnecessary in light of the pending appellate review of the Court’s earlier Section 225 decision concerning the make-

¹³ 8 *Del. C.* § 141(a).

¹⁴ *CA, Inc. v. AFSCME Empls. Pension Plan*, 953 A.2d 227, 234-35 (Del. 2008).

¹⁵ Defs.’ Answering Br. to Pls.’ Mot. for Entry of Status Quo Order at 29.

up of Westech's board, for the Court to resolve the dispute. For now, there are plausible counterarguments that such a bylaw encroaches on the board's managerial power. A shareholder's selection of the company's officers may also be characterized as a substantive business decision, which could thereby constrain the board's managerial powers under 8 *Del. C.* § 141(a). With the benefit of more complete development of the contentions, a reasonable likelihood of success on the merits exists that the bylaw passed by Gorman could encroach on the board's mandate to manage the corporation.¹⁶ This suffices for purposes of the present status quo order, although the need to resolve the question may depend upon further proceedings.

Defendants argue that the harm to Westech and to Defendants outweighs the harm to Plaintiffs. They state that the Court should not countenance the minority shareholders' attempts to gain control of Westech through their tactics of delay and gamesmanship. However, such control is somewhat overstated given the deadlock

¹⁶ The Court therefore need not address Defendants' other arguments. However, the absence of Westech as an indispensable party may easily be redressed when Plaintiffs file an amended complaint, as they indicated they would. Additionally, Defendants have not filed a motion in favor of a stay and thus the questions posed under such an analysis are not yet properly before the Court.

present on the board and Salamone's status as Westech's CEO. Plaintiffs again argue that Gorman will loot the company and destroy its books and records. As discussed above, those arguments are either speculative or unconvincing.¹⁷ Plaintiffs' most compelling argument is that the board is deadlocked and therefore cannot upset the affairs of Westech. Moreover, the risk that routinely occurs in these scenarios in which a new board may function until the summary proceeding is resolved, only to be determined to have been unlawfully empowered, counsels in favor of the status quo order. Thus, the balance of harms weighs in favor of protecting Westech from further uncertainty over the composition of its board.

* * *

The inability of the two separate factions of Westech's directors to work together appears to have caused the managerial direction of the company to have foundered. One might wonder how the incumbent directors hope to retain power

¹⁷ Plaintiffs state that "Gorman, by virtue of the fact that he currently is a director, and will remain a director under the Proposed Order, will be privy to whatever discussions and decisions are made by the Board named in the Proposed Order." Pls.' Mot. for Entry of a Status Quo Order at 17. This is a technically true, although hollow, statement because the incumbent directors are preventing the board from convening. Thus, no board discussions are being held to which Gorman could be privy. Also, Plaintiffs, or Plaintiffs' allies within the company, allegedly are refusing to provide Gorman books and records.

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and evade influence over the company's operations from its majority shareholder Gorman. However, the company's managerial composition is still subject to appellate review and thus the incumbent directors may yet continue to direct the company in spite of its majority shareholder, Gorman. Thus, to some extent this status quo order functions as a stay pending resolution of the cross-appeals to the earlier Section 225 action. Although a stay pending appeal may have been the more appropriate path to avoid the current state of affairs, the status quo order will be granted to preserve the current limited inaction.

* * *

An order addressing these concerns will be entered.

Very truly yours,

/s/ John W. Noble

JWN/cap
cc: Register in Chancery-K