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

PETER FELDMAN,	)	
	)	
Plaintiff,	)	
	)	
v.	)	C.A. No. 1656-N
	)	
RORY J. CUTAIA, STEVEN J. KUMBLE, JONATHAN LAWRENCE, JAMES T. RAYMOND, LLEWELLEN WERNER, WILLIAM HITCHCOCK, LEONARD V. SESSA,	)	
	)	
Defendants,	)	
and	)	
	)	
THE TELX GROUP, INC., a Delaware Corporation,	)	
	)	
Nominal Defendant.	)	

MEMORANDUM OPINION AND ORDER

Submitted: March 15, 2006
Decided: April 5, 2006

Matthew E. Fischer, Esquire, Timothy R. Dudderar, Esquire, Berton W. Ashman, Jr., Esquire, POTTER ANDERSON & CORROON, Wilmington, Delaware, *Attorneys for the Plaintiff.*

Jon E. Abramczyk, Esquire, Lisa Whittaker, Esquire, MORRIS, NICHOLS, ARSHT & TUNNELL, Wilmington, Delaware, *Attorneys for the Defendants.*

LAMB, Vice Chancellor.

The complaint in this lawsuit discusses a series of transactions between March 2002 and August 2003 in which the Telx board of directors allegedly granted themselves a significant equity stake in the company for little or no consideration.[1] The plaintiff alleges that these transactions had the effect of significantly diluting his equity position in the company from 10.3% to approximately 1.5%. Moreover, the plaintiff claims that he was not informed about and was unaware of these events until after the transactions took place and that he was unaware of the participation of the individual defendants and their affiliates in these transactions until he received documents from the company in connection with a recently concluded books and records action filed pursuant to Section 220 of the Delaware General Corporation Law ("DGCL").[2]

In addition, the plaintiff asserts several claims with respect to an August 29, 2005 self-tender offer by the company for $5 million worth of its securities. First, the plaintiff alleges that the director defendants, who own approximately 89% of Telx's options and warrants, specifically structured the repurchase to include

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[1] The facts recited in this opinion are taken from the well pleaded allegations of the amended complaint ("Compl."), unless otherwise noted, and are presumed to be true for the purposes of this motion.

[2] The plaintiff made a demand on Telx in accordance with 8 *Del. C.* § 220 on February 11, 2004, requesting books and records relating to the challenged transactions alleged in the complaint. When the plaintiff did not receive a response to his demand after several months, he brought a Section 220 action in this court on August 6, 2004. The parties settled the dispute in May 2005 when the company agreed to produce documents in several of the categories sought by the plaintiff. A formal stipulation and order of dismissal was entered on May 9, 2005.

options and warrants and set the price term far above fair value in order to impart value to those otherwise underwater options and warrants.

Second, the plaintiff alleges that the repurchase caused an impairment of the company's capital in violation of Section 160 of the DGCL. The plaintiff asserts that, based on the financial information provided to the stockholders in the disclosure document accompanying the repurchase offer, it is apparent that "the repurchase amount of $5 million clearly exceeds Telx's surplus thus causing an impairment of Telx's capital in violation of 8 *Del. C.* § 160."[3]

Finally, the plaintiff claims that the repurchase offer disclosure document contains several material misstatements and omissions. The complaint alleges, among other things, that the defendants failed to disclose (1) an explanation for their decision to repurchase $5 million worth of securities, (2) how they arrived at the $10 repurchase price, and (3) why they chose to include options and warrants, which were predominantly owned by the Telx directors, in the repurchase.

With respect to the claims regarding the repurchase, the plaintiff seeks rescission of the repurchase of any company securities held by participating individual directors, and/or rescissory damages.

The defendants have moved to dismiss the amended complaint under Court of Chancery Rules 12(b)(6) and 23.1. The defendants argue that the plaintiff did

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[3] Compl. ¶ 44.

not make a demand on the Telx board before proceeding with this derivative action and that the amended complaint does not plead with particularity facts that create a reasonable doubt as to the ability of the Telx board to independently consider such a demand. In addition, the defendants argue that the plaintiff's claims for wrongful dilution, breach of the fiduciary duty of loyalty, violation of 8 *Del. C.* § 160, breach of the fiduciary duty of candor, and rescission should all be dismissed for failure to state a claim upon which relief may be granted.

Oral argument was held on March 15, 2006, at which time the court denied the motion in its entirety. This opinion sets forth the reasons for the court's decision.

I.

A. <u>The Parties</u>

Nominal defendant The Telx Group, Inc. is a privately held Delaware corporation with its principal place of business in New York, New York.[4] Telx is a start up company that provides interconnection facilities and services to telecommunications and internet companies.[5] The individual defendants, Rory J. Cutaia, Steven J. Kumble, Jonathan Lawrence, James T. Raymond, Llewellen

[4] In August 2000, the company was incorporated in Delaware under the name CSP Holdings, Inc. and was renamed The Telx Group, Inc. in December 2000.
[5] Telx operates a carrier neutral interconnection facility in New York City that provides network access to more than 100 carrier and enterprise networks.

Werner, William Hitchcock, and Leonard V. Sessa, comprise the current Telx board of directors. Cutaia is the Chief Executive Officer, President and Chairman of Telx's board of directors. Lawrence is Telx's Chief Financial Officer and Chief Operating Officer. It is alleged that the defendant directors, including their family members and entities which they control, collectively hold over 60% of the company's equity and approximately 89% of the company's outstanding options and warrants.

The plaintiff, Peter Feldman, was a co-founder, Chief Technology Officer, and is a former director of Telx.[6] Feldman is a record and beneficial owner of Telx common stock.

B. The Private Placement Offering, Exchange Transaction, Recapitalization, And Reverse Stock Split

In 2002, Telx conducted a private placement offering in which it offered common stock and debt in the form of senior secured and subordinated convertible promissory notes at a 16% interest rate due June 2005.[7] The plaintiff alleges that the documents obtained by him in the Section 220 action disclose that millions of dollars worth of the 16% notes were issued to Telx directors and officers, including five of the seven director defendants, Hitchcock, Sessa, Cutaia, Lawrence, and

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[6] The plaintiff co-founded Telx with defendant Cutaia and other investors.
[7] The total face value of the 16% notes issued equaled $7.05 million.

Raymond, individually and through their family members and entities they control.[8]

In April 2003, the company conducted an exchange transaction, pursuant to which the 16% notes issued in the private placement were exchanged for a combination of newly issued 9% senior secured promissory notes and reduced strike prices on associated warrants to purchase Telx common stock.[9] A total of $5,543,797 of the senior secured 16% notes were exchanged for 9% notes, and approximately $1.1 million worth of the subordinated convertible 16% notes were converted into 3.3 million shares of Telx common stock at a price of $0.34 per share. Allegedly, Telx directors and officers, and their family members and entities they control, were significant participants in the exchange transaction, "exchanging millions of dollars of 16% notes they received in the private placement for 9% notes, warrants and common stock."[10] The same five director defendants that participated in the private placement, Hitchcock, Sessa, Cutaia,

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[8] Specifically, it is alleged that the following individual defendants and their affiliates received the 16% notes in the private placement: (i) Hitchcock and affiliates Avalon Financial Group, Ltd., Rosalie B. Hitchcock and Margaret M. Hitchcock Fanning, (ii) Sessa, (iii) Cutaia (through the Cutaia Group, L.L.C.), (iv) Lawrence and affiliate Joseph S. Lawrence, Jr., IRA, and (v) Raymond and affiliates Barbara K. Raymond, J. Todd Raymond, James F. Fitzgerald IRA, Mystic Island Corporation, Arthur & Elanor Foss, John E. Friend, II, M.D. and Kimberly K. Raymond, John Friend LLC, Kevin Lynch Trust and Friend Family Revocable Trust.

[9] The reduced strike prices ranged from $0.34 to $0.50 per share.

[10] Compl. ¶ 20.

Lawrence, and Raymond, also participated in the exchange, individually and through their family members and entities they control.[11]

In August 2003, the company engaged in a recapitalization whereby the company received $3.8 million in cash and converted $7.8 million of debt and accrued interest into Series A preferred stock. The Series A preferred stock was convertible into Telx common stock on a ten-to-one basis.[12] Again, allegedly Telx directors and officers, including the five director defendants, Hitchcock, Sessa, Cutaia, Lawrence, and Raymond, individually and through their family members and entities they control, participated in the recapitalization, converting into Series A preferred stock millions of dollars of the 9% notes they received through the exchange transaction.[13]

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[11] The following individual defendants and affiliates participated in the exchange transaction: (i) Hitchcock and affiliates Avalon Financial Group, Ltd., Rosalie B. Hitchcock and Margaret M. Hitchcock Fanning, (ii) Sessa, (iii) Cutaia (through the Cutaia Group, L.L.C.), (iv) Lawrence and affiliate Joseph S. Lawrence, Jr., IRA, and (v) Raymond and affiliates Barbara K. Raymond, J. Todd Raymond, James F. Fitzgerald IRA, Mystic Island Corporation, Arthur & Elanor Foss, John E. Friend, II, M.D. and Kimberly K. Raymond, John Friend LLC, Kevin Lynch Trust and Friend Family Revocable Trust.

[12] The Series A preferred stock was issued at four different prices depending upon the level of seniority of the debt exchanged: $1.80 per share for new capital and accrued interest and past-due debt; $2 per share for the senior secured 16% notes and the 9% notes; $3.40 per share for the subordinated convertible 16% notes; and $4 per share for the 12% and 10% junior subordinated debt.

[13] Specifically, the following individual defendants and their affiliates participated in the recapitalization by converting 9% notes into Series A preferred stock: (i) Hitchcock and affiliates Avalon Financial Group, Ltd., Rosalie B. Hitchcock and Margaret M. Hitchcock Fanning, (ii) Sessa, (iii) Cutaia (through the Cutaia Group, L.L.C.), (iv) Lawrence and affiliate Joseph S. Lawrence, Jr., IRA, and (v) Raymond and affiliates Barbara K. Raymond, J. Todd Raymond, James F. Fitzgerald IRA, Mystic Island Corporation, Arthur & Elanor Foss, John E. Friend, II, M.D. and Kimberly K. Raymond, John Friend LLC, Kevin Lynch Trust and Friend Family Revocable Trust.

In September 2003, Telx conducted a ten-to-one reverse stock split in which the preferred stock acquired in the exchange transaction and convertible into common stock on a ten-to-one basis became convertible into common stock on a one-to-one basis. These transactions indicated a value for the common stock ranging from $0.18 to $0.40 per share (or $1.90 to $4 per share assuming that the convertible feature was adjusted to one-to-one following the reverse stock split).

The plaintiff alleges that these transactions enabled the company's board and senior management, and their family members and entities they control, to amass holdings of approximately 60% of Telx's equity and 89% of Telx's outstanding options and warrants. It is alleged that these transactions also diluted Telx's common stockholders, including the plaintiff.[14] The plaintiff alleges that, based on the documents the company produced (and did not produce) pursuant to the Section 220 action, there are no records disclosing any consideration received by the company in exchange for the 16% notes issued to the director defendants, and their family members and entities they control, in the private placement.[15]

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[14] Compl. ¶ 18.

[15] Compl. ¶ 23. According to the complaint, "[d]espite specifically requesting in the 220 Action 'all documents evidencing outstanding loans on which the Company is the obligor including . . . promissory notes, security interests [and] indentures' and agreeing to settle the 220 Action on the basis of a representation from the Company's counsel that the Company had produced 'supporting documents for equity investments in the March 2002 Private Placement and underlying promissory notes and debt agreements,' very few, if any, documents evidencing receipt of consideration by the company in exchange for securities issued pursuant to the Private Placement were produced to plaintiff."

Furthermore, with the exception of defendant Kumble, individual defendants, Hitchcock, Lawrence, Cutaia, Sessa, Raymond, and Werner,[16] either directly or through entities they control, were allegedly issued significant amounts of notes and securities in the private placement for little or no consideration.[17] In addition, the company's financial statements for 2002, the year in which the private placement took place, allegedly support the claim that a significant amount of the 16% notes were issued to the director defendants for grossly inadequate or no consideration.[18]

Moreover, the plaintiff claims that the documents produced through the Section 220 action raise questions concerning the procedure by which the Telx board approved these transactions. Allegedly, the recapitalization was

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[16] The court notes the inconsistency between ¶ 29 of the complaint (alleging that Werner received notes and securities in the private placement for little or no consideration) and ¶ 19 of the complaint (not listing Werner as a participant in the private placement).

[17] For example, allegedly defendant director Lawrence received a significant equity stake of Telx through these transactions for little or no consideration. Lawrence was issued 16% notes with a face value of $321,959 in the private placement. Following the exchange transaction, the recapitalization, and the reverse stock split, with little or no investment, Lawrence amassed a total of 256,369 shares of common stock or common stock equivalents. Excluding warrants and options, Lawrence held approximately 3.4% of the company's outstanding common stock or common stock equivalents as of October 31, 2004. Allegedly, despite specific requests from the plaintiff in the Section 220 action, the company did not provide any evidence of consideration in exchange for any of the securities Lawrence purportedly held, including the 16% notes and common stock, with the exception of two checks: one dated January 15, 2003 in the amount of $26,000 and the other dated August 12, 2003 in the amount of $5,000.

[18] The complaint states: "According to the Company's 2002 financial statements, the Company issued $7.05 million of 16% Notes in the Private Placement. However, the statement of cash flows contained in the same 2002 financial statement discloses that the Company received only $5.08 million in proceeds from long term debt in 2002—nearly $2 million less than the face value of the notes issued." Compl. ¶ 30.

consummated before the Telx board was informed about the fairness of the transaction. According to the complaint, "the recapitalization was completed by August 15, 2003, yet board minutes indicate that the defendants were not informed of the results of the fairness opinion by their financial advisor until August 21, 2003."[19] Furthermore, it is alleged that the board minutes reveal that as of a September 24, 2003 meeting the board still had not received a copy of the completed fairness opinion.

C. The Repurchase

On August 29, 2005, Telx announced an offer to repurchase up to $5 million worth of its securities. The repurchase was open to all holders, including directors and senior management, of common stock, Series A preferred stock, and vested options and warrants with an exercise price of less than $10 per share. The repurchase, which was set to expire on September 23, 2005, had a purchase price per share of common and preferred of $10, as well as $10 per option and warrant minus the underlying applicable exercise price.[20]

In the event that Telx security holders tendered more than $5 million worth of Telx's securities, the company would apply a proration formula to determine the percentage of securities that it would repurchase from each security holder. Based

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[19] Compl. ¶ 31.
[20] To finance the repurchase, Telx sought a $5 million extension of credit with its current credit facility.

upon the proration formula, the repurchase guaranteed the largest share of the repurchase funds to those who held the most eligible securities.[21] Moreover, should the repurchase be oversubscribed, holders of more than one type of security could choose to have the company repurchase a particular type of security first. Thus, for example, those who held common stock as well as options and warrants could tender their options and warrants first.

The plaintiff alleges that the company did not disclose any information indicating how it derived the $10 per share repurchase price, or the uniform pricing structure it offered for common and preferred stock classes as well as options and warrants. According to the complaint, "nothing in the Company's history, whether looking to its financial condition or the prices at which shares have historically or recently traded, indicates a per security price even approaching $10.00."[22] Allegedly, the Telx stock never sold for more than $4 per share (adjusted for the reverse stock split) and in most cases sold well below that amount. For example, the common stock was offered at $2.70 per share (adjusted for the reverse stock

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[21] According to the proration formula, Telx would purchase from each tendering security holder securities having a net equity value equal to the lesser of (1) the net equity value of the securities tendered by such security holder or (2) such security holder's proportionate net equity value, as it related to the overall value of outstanding securities. Should security holders tender less than the proportionate net equity value of their securities, Telx would then purchase additional securities from those holders who tendered more than their proportionate net equity value, pro rata, based on the net equity value of their tendered securities.
[22] Compl. ¶ 37.

split) in the March 2002 private placement.[23] The complaint alleges that "nothing in Telx's performance or disclosed earnings in . . . the two or three years since the recapitalization and the private placement would justify a three- to five-fold increase in the value of Telx securities."[24] Therefore, the plaintiff claims that the $10 per security price is "severely inflated," presumably to give value to the options and warrants disproportionately held by the defendants.[25]

At the time of the repurchase, Telx directors and executive officers beneficially owned approximately 42% of Telx's common stock, 37% of Telx's outstanding Series A preferred stock, and, most significantly, approximately 89% of Telx's outstanding options and warrants.[26] The options and warrants, which were fully vested and convertible into Telx stock at any time, had exercise prices ranging from $0.10 to $3.40. Therefore, allegedly, the Telx directors who owned a large number of options and warrants at exercise prices well below the $10

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[23] Also, according to the complaint, in August 2003, pursuant to the recapitalization, the company retired approximately $7.8 million worth of debt in exchange for Series A preferred shares at between $1.80 and $4.

[24] *Id.*

[25] Compl. ¶¶ 37, 39. The company's presumed market capitalization contemplated in the repurchase would, accounting for all outstanding common and preferred stock as of July 31, 2005, equal $76,045,940. Allegedly, such a value exceeds by several times an appropriate market capitalization for a company in Telx's financial condition.

[26] According to the repurchase disclosure document, a group of eight unidentified Telx directors and executive officers beneficially owned, in the aggregate, 795,894 shares of common stock, 2,133,337 shares of Series A preferred stock, and 1,776,781 eligible options and warrants with exercise prices ranging from $0.10 to $3.40.

repurchase price were to substantially benefit from the transaction. According to the complaint:

> The repurchase does not serve any legitimate corporate interest. Instead, it merely serves as a means for the Company's directors and senior management to cash in at least some of their holdings—holdings which they cannot demonstrate were properly acquired—at a per security price that exceeds by several times any reasonable estimate of their value.[27]

Furthermore, given the structure and terms of the repurchase, the defendants could tender their otherwise underwater options and warrants and receive a significant amount of the proceeds without diluting their ownership interest in the company.

II.

Section 141(a) of the DGCL provides that "the business and affairs of every corporation organized under this chapter shall be managed by or under the discretion of a board of directors."[28] Within this authority is the decision whether or not to bring litigation on behalf of the corporation.[29] Accordingly, a stockholder wanting to initiate a lawsuit on behalf of the corporation pursuant to Court of Chancery Rule 23.1 must first make demand on the corporation's board of directors to take the requested remedial action or demonstrate the futility of such a

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[27] Compl. ¶ 2.
[28] 8 *Del. C.* § 141(a).
[29] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (stating that "[t]he demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of the corporation").

demand.[30] The test of futility is whether at the time of the filing of suit a majority of the directors could have impartially considered and acted upon the demand.[31]

In *Aronson v. Lewis*, the Delaware Supreme Court held that, in determining demand futility, the court must decide whether, "under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[32] When determining whether a derivative complaint creates a reasonable doubt, "plaintiffs are entitled to all reasonable factual inferences that logically flow from the particularized facts alleged, but conclusory allegations are not considered as expressly pleaded facts or factual inferences."[33]

In this case, the plaintiff failed to make a pre-suit demand on the board. Instead, the complaint alleges that a majority of Telx's directors are incapable of impartially considering a demand to pursue claims relating to the challenged transactions. As discussed herein, the court finds that the plaintiff has met the first prong of *Aronson*. Therefore, the court will deny the defendants' motion to dismiss and permit the plaintiff to proceed with this derivative suit.

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[30] *Brehm v. Eisner*, 746 A.2d. 244, 245-55 (Del. 2000).
[31] *Aronson*, 473 A.2d at 809-10 (stating that "futility is gauged by the circumstances existing at the commencement of a derivative suit").
[32] *Id.* at 814.
[33] *Brehm*, 746 A.2d at 255.

The plaintiff claims, *inter alia*, that a majority of the Telx directors engaged in self-interested transactions in violation of their duty of loyalty. The plaintiff's allegations with respect to the first prong of *Aronson* are two-fold. First, the plaintiff alleges that a majority of Telx directors received securities in the private placement transaction for little or no consideration. Second, the plaintiff alleges that a majority of the Telx directors engaged in a self-dealing transaction in which they caused the company to repurchase at a grossly inflated price options and warrants held almost exclusively by those directors. These allegations, if true, create a reasonable doubt that the directors were disinterested in approving the challenged transactions.

To establish director interest sufficient to excuse demand, the plaintiff must plead particularized facts showing that a majority of the Telx board had either a financial interest not equally shared by the stockholders, or an entrenchment purpose.[34] Here, the test is satisfied by the plaintiff's allegation, stated with particularity, that a majority of the directors received securities of the company in the private placement transaction for little or no consideration.[35] Furthermore, the

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[34] *Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988).

[35] At oral argument, the defendants maintained that, because the Telx outside financial auditors certified the company's financial statements, it is reasonable to conclude that valuable consideration was paid to the company. The court cannot reasonably rely at a motion to dismiss stage on a mere statement made by a defendant that an outside auditor certified the financials of the company. The issue is whether the director defendants paid consideration for the notes they received in the private placement. This is an issue of objective fact that cannot be proved by the existence of an auditor's certification.

allegations with respect to the repurchase suggest that the self-tender offer was an interested transaction subject to the entire fairness standard of review.

The defendants argue that the repurchase is not an interested transaction because all security holders can participate in the transaction on equal terms. They contend that, even though the directors had a financial interest in the offer in the sense that they owned Telx securities, they did not have an interest in the offer that would disqualify them from objectively considering a demand to bring derivative claims related to that offer. The court is unable to accept this argument because, taken as true, the particularized allegations of fact in the complaint support a reasonable probability that a majority of the Telx directors were financially interested in the repurchase and stand to receive a financial benefit *not* equally shared by the company's stockholders.

By deciding to include options and warrants in the repurchase, the directors, who owned approximately 89% of Telx's options and warrants, allowed themselves to claim a larger percentage of the repurchase proceeds. Allegedly, the repurchase was structured such that the directors could potentially receive a disproportionate benefit from the transaction than they would otherwise have been entitled to had the repurchase only included outstanding common stock.[36] Thus,

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[36] The number of options and warrants eligible for repurchase was substantial. Indeed, the amount of options and warrants eligible for repurchase was greater than the total amount of common stock outstanding.

the decision to include options and warrants in the repurchase, while not necessarily suspect, when coupled with the other factors discussed next, suggests that the individual director defendants placed their own interests above those of the Telx stockholders.[37] Similarly, the proration formula allowed the directors to first tender their options and warrants in the repurchase without a concomitant reduction of their ownership percentage in the company. To the extent that the directors planned to tender their options and warrants while retaining their common and preferred stock, they could be unfairly advantaging themselves to the detriment of the common stockholders.

Most important, by setting the repurchase price at $10, the directors made it possible to receive cash for their options and warrants at a price allegedly far in excess of the value of these securities. Had the directors instead priced the repurchase at what is alleged to be fair value, many, if not all of the options and warrants would have been "out of the money." Instead, the directors allegedly chose "to cash out these securities at a price well above their exercise price and

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[37] In addition, the court notes that the directors may have improperly put the interests of the option and warrant holders above the interests of the common stockholders. The Delaware Supreme Court has consistently held that directors do not owe fiduciary duties to future stockholders. *See Simons v. Cogan*, 549 A.2d 300, 303 (Del. 1988) (holding that a "convertible debenture represents a contractual entitlement to the repayment of a debt and does not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties"); *Cont'l Airlines v. American Gen.,* 575 A.2d 1160, 1168 (Del. 1990) (explaining that warrant holders are only protected by contractual rights); *Glinert v. Wickes Cos.*, 586 A.2d 1201 (Del. 1990) (holding that a corporation did not owe a fiduciary duty to future stockholders).

well above a price these holders would otherwise be able to obtain without the repurchase."[38] In addition, the claim that the company did not disclose why the directors chose a $10 repurchase price or how this price was calculated further supports the suggestion that the directors had an improper motive to cash out their less valuable (or valueless) options and warrants at an inflated price.[39]

For these reasons, the court concludes that the plaintiff has alleged with particularity facts which, if true, are sufficient to raise a reasonable doubt as to whether the directors could properly entertain the plaintiff's demand. Accordingly, the court will deny the defendants' motion to dismiss pursuant to Rule 23.1.

III.

The defendants have also moved under Court of Chancery Rule 12(b)(6) to dismiss the claims that: (1) the repurchase violates Section 160(a)(1) of the DGCL; and (2) the directors breached their fiduciary duty of candor by disseminating a disclosure document pursuant to the repurchase that contains material misstatements and omissions.

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[38] Compl. ¶ 42.

[39] In addition, the Telx directors have acknowledged in the disclosure document that the board has explored a possible merger transaction with a third party or another recapitalization. Allegedly, "[t]he repurchase therefore affords the individual defendants the opportunity to cash in a significant portion of their holdings now at a per share value that the individual defendants know would not be available in a negotiated transaction with a third party such as a merger or recapitalization." Compl. ¶ 41.

The standard for dismissal pursuant to Rule 12(b)(6) for failure to state a claim upon which relief can be granted is well established. A motion to dismiss will be granted if it appears with reasonable certainty that the plaintiff could not prevail on any set of facts that can be inferred from the pleading.[40] That determination is generally limited to the factual allegations contained in the complaint. In considering this motion, the court must assume the truthfulness of all well pleaded allegations of fact in the complaint.[41] All well pleaded facts and inferences that can reasonably be drawn therefrom are accepted as true.[42] However, with that said, a trial court need not blindly accept as true all allegations, nor must it draw all inferences from them, in the plaintiff's favor unless they are reasonable inferences.[43]

A. Section 160(a)(1)

The plaintiff alleges that Telx's repurchase of its shares will cause an impairment of Telx's capital within the meaning of 8 *Del. C.* § 160(a)(1). The plaintiff bases his allegation on the pro forma balance sheet provided in the disclosure document which reveals that the repurchase amount of $5 million far

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[40] *Kohls v. Kenetech,* 791 A.2d 763, 767 (Del. Ch. 2000).
[41] *Grobow*, 539 A.2d at 188 n.6 (upon a motion to dismiss, "all facts of the pleadings and reasonable inferences to be drawn therefrom are accepted as true, but neither inferences nor conclusions of fact unsupported by allegations of specific facts upon which the inferences or conclusions rest are accepted as true").
[42] *Id.*
[43] *Id.*; *In re Lukens Inc. S'holders Litig.,* 757 A.2d 720, 727 (Del. Ch. 1999).

exceeds Telx's surplus.[44] Section 160(a)(1) provides that a corporation may not repurchase or redeem its own shares "when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital of the corporation." A repurchase impairs capital if the funds used in the repurchase exceed the amount of the corporation's surplus, as defined in 8 *Del. C.* § 154 to mean the excess of net assets over the par value of the corporation's issued stock.

The defendants rely on *Klang v. Smith's Food and Drug Centers* for the proposition that Section 160 was not violated because the company has the ability to revalue its assets to conform to the requirements of the statute.[45] It is true that, in *Klang*, the Delaware Supreme Court held that a corporation *may* revalue its assets and liabilities to show a surplus and thus conform to Section 160.[46] Unlike in *Klang*, however, where the board in fact appropriately revalued its corporate assets to comply with the statute, here it is alleged that the Telx board did not perform such a revaluation.[47] Moreover, *Klang* was decided after the parties took

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[44] According to the summary balance sheet contained in the disclosure document, Telx has total assets of $63,554,213 and total liabilities of $61,561,337, which results in net assets of $1,992,876. Subtracting the aggregate par value of Telx's outstanding equity ($76,045) from its net assets leaves a surplus within the meaning of 8 *Del. C.* § 154 of $1, 916,831. Therefore, the repurchase amount of $5 million exceeds Telx's surplus, resulting in an impairment of Telx's capital in violation of 8 *Del. C.* § 160.
[45] 702 A.2d 150, 154 (Del. 1997).
[46] *Id.*
[47] *Id.* at 155.

full discovery and the court had before it a fully-developed factual record.[48] In the present matter, the court is confined to the allegation in the complaint that the company lacked adequate surplus and did not revalue its assets to create sufficient surplus.

In the circumstances, it would be unreasonable for the court to assume, contrary to the well pleaded facts, that the company actually revalued its assets to comply with Section 160. Such an assumption would effectively render meaningless the statutory prohibition against conducting a repurchase that impairs the company's capital. Accordingly, the court finds that the plaintiff has properly alleged a claim that the repurchase violated Section 160(a)(1).

B. Disclosure Claims

The plaintiff alleges that the Telx directors breached their fiduciary duty of candor by disseminating a disclosure document with respect to the repurchase that contains several material misstatements and omissions. Specifically, the plaintiff claims, *inter alia*, that the defendants failed to fully and accurately disclose in the offer to purchase (1) relevant, up-to-date financial information, (2) the justification for their decision to repurchase $5 million worth of Telx stock with borrowed funds, (3) any information concerning the source or derivation of the $10 per security purchase price, (4) the effect on common stockholders if they decide not to

[48] *Id.* at 153.

participate in the repurchase, (5) the nature and extent of the directors' ownership and intended participation in the repurchase, (6) why they included options and warrants in the repurchase, and (7) whether Telx was engaged in preliminary merger negotiations at the time it commenced the repurchase.[49]

Under Delaware law, "a board of directors is under a fiduciary duty to disclose material information when seeking shareholder action."[50] This fiduciary disclosure obligation involves the affirmative duty to provide information, the duty to be materially accurate and complete with respect to the information that is provided, and the duty to be entirely fair by fully disclosing material information.[51] Here, the plaintiff alleges that the stockholders could not make an informed

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[49] Moreover, the plaintiff claims that prior to the expiration date of the repurchase he wrote to the company expressing his concerns regarding the omission of material information in the disclosure document. Allegedly, he was told that the company would disseminate a supplement to the disclosure document which would address his concerns. The plaintiff claims never to have received any supplemental disclosures.

[50] *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998) *citing Loudon v. Archer-Daniels-Midland Co.,* 700 A.2d 135, 137-38 (Del. 1997) ("Delaware law of the fiduciary duties of directors . . . establishes a general duty to disclose to stockholders all material information reasonably available when seeking stockholder action . . . . But there is no per se doctrine imposing liability . . .); *Arnold v. Soc'y for Sav. Bancorp,* 650 A.2d 1270, 1277 (Del. 1994) (a fiduciary disclosure obligation "attaches to proxy statements and any other disclosures in contemplation of shareholder action"); *Stroud v. Grace,* Del. Supr., 606 A.2d 75, 84 (Del. 1992) ("directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action").

[51] *See Stroud*, 606 A.3d at 84 (recognizing an affirmative duty to provide information to stockholders); *see also Shell Petroleum v. Smith*, 606 A.2d 112, 114 (Del. 1992); *Kahn v. Roberts*, 679 A.2d 460, 462 (Del. 1996) (finding a duty to be materially accurate and complete when management is seeking stockholder action); *see also Arnold*, 650 A.3d at 1277; *Sealy Mattress Co. of N.J. v. Sealy Inc.*, 532 A.2d 1324, 1340 (Del. Ch. 1987) (holding that the duty of fairness includes an obligation to make full disclosure).

decision on whether to participate in the tender offer because the company's disclosure document is materially misleading.

The complaint adequately alleges that the directors failed to disclose all facts material to the tender offer.[52] In particular, the failure to adequately disclose the purpose of the transaction and how the unusually high $10 per security purchase price was derived may prove to be material omissions.[53] The duty to disclose material information such as this is especially important where, as here, the securities that are the subject of the repurchase are not publicly traded, leaving the stockholders without a market price against which to measure the adequacy of the proposal.

Lastly, the plaintiff alleges that the disclosure document did not adequately disclose that certain Telx directors had a potential conflict of interest by reason of their ownership of significant amounts of Telx options and warrants. Allegedly, a conflict exists between the directors and the common stockholders because the directors, who owned approximately 89% of Telx options and warrants, could disproportionately benefit over the common stockholders in the tender offer. If

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[52] *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1057 (Del. Ch. 1987) ("Where a corporation tenders for its own shares, the exacting duty of disclosure imposed upon corporate fiduciaries is even 'more onerous' than in a contested offer. That is because in a self-tender, the disclosures are unilateral and not counterbalanced by opposing points of view.").

[53] *See Gaffin v. Teledyne*, 611 A.2d 467, 473 (Del. 1992); *see also Eisenberg*, 537 A.2d at 1059 (explaining that "the shareholder-offerees are entitled to an accurate, candid presentation of why the self-tender is being made" and "are to be informed of information in the fiduciaries' possession that is material to the fairness of the price").

true, the common stockholders are entitled to know that certain of their fiduciaries had a self-interest that was arguably in conflict with their own interests.[54] Therefore, the court will not dismiss the plaintiff's disclosure claims at this early stage of the litigation, before the basic facts relating to the challenged transactions and the repurchase offer are established of record.

IV.

For the foregoing reasons, the defendants' motion to dismiss pursuant to Rule 12(b)(6) is DENIED. IT IS SO ORDERED.

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[54] *Eisenberg*, 537 A.2d at 1061 (explaining that directors are obligated to disclose their conflict of interest with respect to a self-tender offer).