



IN THE SUPREME COURT OF THE STATE OF DELAWARE

ALBERT POLIAK,	)	
	)	
Defendant Below,	)	
Appellant,	)	
	)	
v.	)	No. 478, 2012
	)	
ROBERT D. KEYSER, JR., FRANK	)	On appeal from the
SALVATORE AND SCOTT SCHALK,	)	Court of Chancery of
	)	the State of Delaware
Plaintiffs Below,	)	in C.A. No. 7109-VCN
Appellees,	)	
	)	
and	)	
	)	
ARK FINANCIAL SERVICES, INC.,	)	
	)	
Nominal Defendant	)	
Below, Appellee.	)	

REPLY BRIEF OF DEFENDANT-BELOW, APPELLANT ALBERT POLIAK

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INTRODUCTION

This appeal presents two issues. First, does laches bar plaintiffs (who have full knowledge of the facts and the law) from deliberately delaying filing suit for the express purpose of having their company sell stock to third-party investors, but who then later file suit over their pre-existing claims attacking the company's capital structure? Second, do plaintiffs who accept the benefits of their company's sale of stock relinquish the right to attack the very capital structure that supported that sale of stock? These are important issues because they go to the integrity of a Delaware corporation's capital structure as represented to potential investors.

Appellees do not argue that Poliak's policy arguments on what is or should be Delaware law are wrong. Instead, they focus on whether anyone was really prejudiced by their delay in filing suit. They are then forced to rely on the trial court's conclusion that new investors do not rely on current management when they invest. Thus, the appeal turns first on whether the trial court's conclusion is the product of an orderly and logical deductive process. It is not, as this brief will show. Similarly, Appellees claim they received no benefit when Poliak's control saved Ark from insolvency and caused Keyser to be paid \$400,000 from the Series A Preferred Stock issuance. That too is not a logical conclusion.

Appellees also unsuccessfully try to avoid these issues by attacking Poliak's conduct, labeling it "egregious" and claiming he acted "despite the advice of counsel." (Answering Brief of Plaintiffs-Below, Appellees (hereinafter cited as "AB__") at 17 and 6

(emphasis in original).) They go so far as to accuse Poliak of having "misappropriated Company assets" (*Id.* at 6), a claim they never tried to support at trial and a claim implicitly rejected by the Court of Chancery when it rejected Keyser's excuses for wrongly refusing to abide by his contract to sell his Ark stock. (Opinion at 25-28.) These attacks are a diversion to obscure the real issues before this Court. This brief focuses on those issues.¹

¹ To set the record straight, however, we note the following: (1) Ark was insolvent in 2010 and under those circumstances it is understandable why the Series B Preferred Stock issuance price was "arbitrar[y]" and redeemable for \$1.00 per share (a price higher than the exercise price of the Option Shares Keyser acquired) (A261, Poliak; A19 ¶ 13.); (2) Locke Lord drafted the corporate documents issuing the Series B Preferred Stock, advised Poliak and Shek that issuance was valid if controversial and later defended that issuance (A255-57; A847-52; A866-79; A880-87; A989); and (3) Poliak had understandable grounds to fear a Keyser takeover and, as the Court of Chancery expressly found, acted to protect Ark from Keyser and the Three Creditors. (Opinion at 6.) Poliak may have been ill advised, but he was not acting baselessly.

ARGUMENT

I. LACHES BARS THOSE WHO DELAY WHEN OTHERS ARE PREJUDICED AS A RESULT OF THAT DELAY

A. Appellees Cannot Ignore The Evidence Establishing Laches

Appellees recognize that they need to counter the main point raised in Poliak's Opening Brief: that the Series A Preferred investors relied on Ark's capital structure when they invested in Ark. (AB at 21-24.) Accordingly, Appellees argue that: (a) the Court of Chancery concluded the Series A Preferred investors did not rely on Poliak's control as a result of the Series B Preferred Stock issuance (*Id.* at 22), (b) no third-party investors testified as to their reliance (*Id.* at 22-23), and (c) Curtis's testimony on his and others' reliance was "self-serving." (*Id.* at 23-24.) None of these arguments should prevail here.

1. The Opinion reached an illogical conclusion

In his opening brief, Poliak pointed out all the evidence (including the testimony of the Appellees) that showed the Court of Chancery's "no-reliance" conclusion is not the product of an orderly and logical deductive process. (Opening Brief (hereinafter cited as "OB__") at 22-26.)² Appellees largely ignore all of that evidence, except to attack Curtis's testimony.

Apparently recognizing that the evidence is contrary to their argument, Appellees instead claim that because the "Series A PPM

² For example, Keyser testified "investors in companies like [Ark] want to know who is on the management team" and that "is a big concern" (A222-23, Keyser) and Schalk and Salvatore testified the private placement memorandum would tell investors "who was in control of Ark." (A454, 412, 419.)

described Poliak's control as a risk factor," that was not important to investors. (AB at 22.) That turns logic on its head. A "risk factor" is disclosed because it is important to investors when they put their money at risk. As the Series A Subscription Agreement made clear, the "risk" is that control of Ark was held by one person - Poliak. (A1083.) The Series A Preferred investors relied upon Poliak's control when they made their \$3,000,000 investment. Appellees' claim turns on the illogical assumption that the investors were betting that Poliak's control would change - just the opposite of the truth. (AB at 23.) That same flawed reasoning underlies the Court of Chancery's conclusion that investors "typically" do not view a controlling stockholder as a positive. (Opinion at 22.) In reality, the existence of a controlling stockholder is a key factor in deciding to invest.

2. The investors' reliance is demonstrated by their investment

Appellees next argue that investor reliance was not proven because no "third-party Series A investors" testified. (AB at 22.) There is no better proof of reliance than putting up \$3,000,000 based upon the management of Ark under Poliak's control. Shek and Poliak testified that they went on a road show to get investors "comfortable" with Ark's management under Poliak. (A358-60, Poliak.) Appellees' argument that reliance was not reasonable because Ark's management might change is unconvincing. (AB at 22-23.) Any present fact that investors rely on (the nature of a company's business, its contracts, etc.) may change some day. But to argue that the possibility of change makes all investor reliance on the business as it is when they

invest unreasonable is absurd. Such an argument would make all reliance on present facts unreasonable, just because those facts may change some day.

3. Curtis's testimony establishes reliance

Next, Appellees argue that Curtis's testimony that he invested \$250,000 of his own money because he relied on Poliak's control should be disregarded as "self-serving" and "not credible." (AB at 23.) The Court of Chancery did not reject Curtis's testimony, which was credible. It would be incredible for Curtis to invest \$250,000 of his own money and encourage his "best customers" to invest \$1.4 million in Ark under Poliak's control while believing, contrary to his own testimony, that Keyser would sue and the Series B Preferred Stock would be rescinded. (A469; A472-73, Curtis.)

B. Appellees' Reliance On Settlement Discussions Does Not Excuse Their Delay

Finally, Appellees raise the legal argument that Keyser's settlement discussions justified Keyser's delay in filing suit. (AB at 19-21.) That argument ignores one key fact - those settlement discussions were over when Keyser signed the Settlement Agreement, which was before the closing on the Series A Preferred Stock issuance. (A1323-29; A1341-42.) There is no evidence anyone other than Keyser was trying to settle any claim before the sale of the Series A Preferred Stock. Prior to Keyser signing the Settlement Agreement, Ark's attorney advised Keyser that there would be no sale of the Series A Preferred Stock (and Keyser would not get \$400,000) unless Keyser gave up his threat to sue over the Series B Preferred Stock. (A1297; A1310-11.) After a deal was struck, Keyser signed the

Settlement Agreement, whereby he agreed to give up his Ark stock and thereby end his ability to contest the issuance of the Series B Preferred Stock. (A1323-29.) He then stood by while Ark sold \$3,000,000 in Series A Preferred Stock and pocketed \$400,000 for himself.

Keyser tries to support his argument by pointing to Section 5 in the Settlement Agreement where he reserved his rights until the Agreement was performed. (AB at 28.) That reliance is misplaced. The Settlement Agreement itself demonstrates that error. Under the terms of the Notes and Settlement Agreements, Keyser gave a broad release of claims. (A1323-29; A1267-81.) He conditioned that release on the performance of the Settlement Agreement by reserving his rights to sue if the Settlement Agreement was not performed. Appellees try to expand that condition by now claiming it means that Keyser retained the right to sue even if Ark performed the Settlement Agreement. (AB at 28.) The record undermines that argument.

As already noted, when Keyser threatened litigation on April 15, 2011, (A1305-09), Locke Lord informed Keyser that if he sued, there would be no Series A Preferred Stock issuance and no purchase of notes held by Auxol. (A1310-11.) The parties then agreed to extend the closing date of the Notes Agreement and Keyser signed the Settlement Agreement to make this threat go away. (A1321-22; A1323-29.) They clearly did not intend to preserve Keyser's right to sue if he sold his stock as he promised. While Keyser later breached the Settlement Agreement, that breach can hardly be used to extend the scope of Keyser's reservation of rights in the Settlement Agreement.

C. Conclusion

Delaware law should require that stockholders with knowledge of a claim that may substantially change the capital structure of a company promptly pursue that claim in court when they know that innocent third-party investors are about to purchase stock in that company based upon the existing control of that company. Otherwise, investors will be misled into believing there is no legal dispute over the management they chose to control their investment. Laches must bar Appellees' claims.

**II. BY ACCEPTING THE BENEFITS OF THE SERIES B PREFERRED STOCK
ISSUANCE, THE APPELLEES ARE BARRED FROM CHALLENGING THAT ISSUANCE**

In his opening brief, Poliak set out the requirements of Delaware law to establish the equitable defenses of ratification, acquiescence and waiver. (OB at 27-28.) The Court of Chancery generally agreed with Poliak's recital of the law and Appellees too do not take issue with Poliak on the law's requirements.

A. Appellees Received And Retained Benefits

The dispute then is over how to determine whether Appellees received and retained a benefit from what Poliak did that is sufficient to meet the test for ratification, acquiescence or waiver. Appellees argue that the issuance of Series B Preferred Stock is sufficiently distinct from the issuance of the Series A Preferred Stock so that Ark's receipt of \$3,000,000 from that issuance should not be deemed a benefit attributable to the issuance of the Series B Preferred Stock. (OB at 33-34.) That argument is contrary to the record.

To begin with, all of the Appellees must admit that the sale of the Series A Preferred Stock did benefit them. After all, Ark was insolvent and the creditors were going to put it out of business, but for the \$3,000,000 raised in April 2011 and \$1,000,000 raised in November 2011. Keyser also received \$400,000 from the Series A Preferred Stock issuance and Salvatore and Schalk too admitted that saving Ark from insolvency benefitted them. (A428, Schalk; A448-49, Salvatore.)

Turning to whether the benefit Appellees received was caused by Poliak's holding the Series B Preferred Stock and controlling Ark,

they indirectly admit that connection. Appellees themselves state that Poliak remained in control because "after Keyser acquired the Option Shares, [he] chose [not to remove Poliak but] instead to work toward a settlement." (AB at 33.) That "settlement" led to the sale of the Series A Preferred Stock by an offering memorandum that was based on Poliak holding the Series B Preferred Stock and controlling Ark.

One only has to consider the alternative to appreciate the direct connection between the benefit received by Appellees and the Series B Preferred Stock. If Keyser, Salvatore and Schalk had removed Poliak in early 2011 after suing to invalidate the Series B Preferred Stock, they would have had to tell any new investor that: (1) Keyser had made a sweetheart deal with the Three Creditors to prefer them over others, including those who were being asked to convert their Ark debt to Series A Preferred Stock, (2) Keyser had previously been forced out of Ark's management in 2010 for poor performance, and (3) Schalk, Salvatore and Keyser all worked for a competitor of Ark and had previously demanded Ark buy out their stock at a price Poliak thought was too high. (OB at 5-8,19.) The Series A Preferred Stock issuance never would have happened with those disclosures.

B. Appellees Facilitated The Sale Of The Series A Preferred Stock

In addition to denying that Poliak's successful efforts to avoid Ark's bankruptcy (and pay Keyser \$400,000) benefited them, Appellees also argue they did not "[t]ake [a]ny [a]ction" that constituted ratification or acquiescence in what Poliak did. (AB at 31.) That is both legally and factually incorrect. As the Court of Chancery

recognized, Delaware law does not require positive action for implied ratification or acquiescence. One who "stands by" may thereby ratify or acquiesce in a transaction. (OB at 42, 46, citing *Genger v. TR Investors, LLC*, 26 A.3d 180, 195 (Del. 2011) and *Brandywine Dev. Group, L.L.C. v. Alpha Trust*, 2003 WL 241727 (Del. Ch. Jan. 30, 2003).)

Appellees did more than just "stand by." Keyser had his lawyer demand a copy of the "financing documents being used by Ark [sic] to raise new funding" (A1294) and entered into the Settlement Agreement for the express purpose of permitting the sale of the Series A Preferred Stock to go forward. *See supra* at 5-6. Salvatore and Kaiser repeatedly talked to Poliak about that sale of Series A Preferred Stock and wanted it to go through to keep Ark alive and in a position to buy their stock. (A363-65, Poliak.) The Court of Chancery expressly found that Salvatore and Schalk knew of the Series B Preferred Stock issuance by December 2010 or January 2011 and "[b]y the spring of 2011, all of the plaintiffs were aware of the proposed private placement of Series A Preferred Stock." (Opinion at 11, 12.)³

C. Poliak Did Not Know Appellees Intended To Challenge The Series B Preferred Stock Issuance When The Series A Preferred Stock Was Issued

Finally, Appellees argue there was neither ratification nor acquiescence because Poliak knew Keyser would sue. (AB at 27-29.) Indeed, they quote from the Opinion where the Court of Chancery found

³ Appellees' claim that Salvatore and Schalk "did not learn [the] relevant facts until much later than Keyser" (AB at 26) is contrary to the Court of Chancery's decision and not supported by the record. (Op. at 11-12; A1727-44.)

"Defendants did know that Plaintiffs intended to challenge the Series B Issuance." (*Id.* at 28 (emphasis omitted).) The problem with that argument is that it ignores the key fact that, regardless of his prior protestations about instituting imminent litigation, Keyser signed the Notes Agreement and Settlement Agreement waiving all his claims if it was carried out, permitted the Series A Preferred Stock to be sold without a single warning he was going to contest Poliak's control and walked off with \$400,000 as a result. There is simply no evidence that Poliak or anyone else understood that despite Keyser's promises in the Notes Agreement and Settlement Agreement in the spring of 2011, that he would later repudiate those promises and file suit.⁴ After all, the offering memorandum (that Keyser and the other Appellees saw) does not even mention the possibility Keyser would sue because no one believed that would happen.

D. Conclusion

All of the Appellees benefitted from the sale of the Series A Preferred Stock to investors who were told Ark was in Poliak's control. They wanted that sale to proceed. Appellees thus ratified the basis for the Series A Preferred Stock sale and acquiesced in its premise - Poliak controlled Ark through his ownership of Series B Preferred Stock. Their claims to the contrary should have been rejected.

⁴ In light of the negotiations among Poliak, Salvatore, Schalk and Kaiser for Ark's purchase of their shares and Keyser's refusal to sell his stock, Curtis and Shek understood that Poliak and his colleagues believed Appellees' objections to the Series B Preferred Stock were simply a negotiating tactic. (A480-81, Curtis; A551, Shek.) In any event, Salvatore and Kaiser sided with Poliak until November 2011.

CONCLUSION

For the reasons set forth above and in the Opening Brief, the judgment of the Court of Chancery should be reversed.

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