Zutrau v. Jansing[1]

A Business Divorce Smorgasbord With Something for Everyone

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PRACTICING THE ART OF LAW

[1] C.A. No. 7457-VCP, 2014 WL 3772859 (Del. Ch. July 31, 2014). The author is currently representing one of the litigants in this matter. The views expressed herein are solely those of the author and do not necessarily represent the views of his firm or his client.

The Parties

Plaintiff Zutrau: 22% stockholder; Former Treasurer & Controller

Defendant Jansing: 78% stockholder; Sole Director & President

Nominal Defendant ICE Systems: the company, engaged in proxy trust business, which has about 13 employees and roughly $3M in annual revenues; admittedly solvent

Prior-Filed New York Action

Zutrau brought claims against Jansing and ICE for (among other things):

- Wrongful removal as Treasurer/Controller (including discrimination claims);
- Breach of oral employment agreement to employ Zutrau until Company could be sold;
- Derivative claims for excessive compensation, waste of corporate funds, use of corporate funds for personal purposes.

The NY court dismissed the derivative claims without prejudice, holding they needed to be brought separately from the wrongful removal claims.

Ultimately ruled in Jansing's favor on all claims, except held that Zutrau was entitled to $60K remaining in her capital account.

Delaware Litigation/Reverse Stock Split

Zutrau refiled her derivative claims in Delaware, originally on a pro se basis. Required to retain counsel.

After filing of the suit, Jansing instituted a Reverse Stock Split that eliminated Zutra's interest in ICE in exchange for $495K, based on a fair value report prepared by Duff & Phelps. (Reverse Stock Split brainchild of Peter Mahler, Esq.)

Zutrau subsequently amended her complaint to include both her **derivative claims** and:

- Challenged Reverse Stock Split, seeking either rescission or a higher valuation of her interest. (Continuous ownership requirement.)
- Requested dissolution of the company.
- Asserted claim for equitable fraud, alleging that Reverse Stock Split violated certain promises or representations Jansing had made to her – that he would not do anything to interfere with her stock ownership or employment until the company could be sold.

Jansing moved to dismiss the dissolution claim, on the grounds that ICE was a solvent company that was not – and could not be – under any director or stockholder deadlock. Jansing also moved to dismiss the equitable fraud claim, on the grounds that it simply rehashed and "bootstrapped" an oral employment contract claim that had already been dismissed by the New York. The Court ultimately denied the motion.

Jansing also made clear that he did not object to the litigation of Zutrau's derivative claims in connection with the challenge to the valuation of the company performed in connection with the Reverse Stock Split.

Post-Trial Decision

- 113 pages

- Opinion, not Memorandum Opinion

Equitable Fraud Claim

- Court did not determine whether alleged promises made; assumed they were for purposes of decision.

- Ruled in Jansing's favor.

- Court found that claim was an effort to rehash or bootstrap the oral contract claim that had been dismissed in the New York Action. (See discussion of motion to dismiss, above.)

- Court found that alleged promises did not constitute fraud because they were non-actionable promises of future performance.

Claims for Breach of Fiduciary Duties

- Claims were derivative. Zutrau technically lacked standing if Reverse Stock Split was valid (continuous ownership requirement). Claims still relevant for valuation purposes. Jansing waived any objection to proceeding in that fashion. (Court seemed to appreciate; might have turned out differently without concession.)
- Derivative claims included a claim that Jansing had failed to replace Zutrau with anyone would could provide competent financial oversight of the company; Jansing had caused the company to pay excessive compensation to himself; that Jansing had caused ICE to pay for his personal expenses; that Jansing had caused ICE to pay unreasonable compensation and benefits to the company's employees; and that Jansing had otherwise wasted corporate assets.

Employee Compensation Claims

- Ruled in Jansing's favor.
- Jansing's decisions regarding employee compensation protected by business judgment rule.
- Microcap company with 13 employees. Jansing could make qualitative decisions about compensation and bonuses and did not need to have a formal, written policy.

Waste Claims

- Ruled in Jansing's favor.
- Challenges did not state claims under strict standard for waste. Claims challenged numerous corporate expenditures, including upgrading accounting software, loaning money to another company with which the company did business, alleged overpayment of vendors, and miscellaneous expenditures including company outings for employees, office supplies, and "an apparently large supply of gummy bear snacks for the office."

Claims re Excessive Compensation to Jansing

- Ruled in Zutrau's favor.
- Jansing's decisions about his own compensation subject to entire fairness review, which places burden on the defendant of showing fair price and fair dealing.
- Jansing did not meet burden of showing fair dealing, because evidence did not establish there was independent review or objective basis for compensation determinations, notwithstanding company's size and prior practice.
- Jansing did not meet burden of showing fair price, in part because evidence showed that he had much lower bonuses when Zutrau was still employed at company; Court rejected Jansing's compensation expert's determination that his overall compensation was fair based on problems with selection of Peer Group and other matters; and Court ultimately determined based on a number of factors (including the company's historical performance and Jansing's historical compensation) that Jansing's bonuses should have been 44% lower from 2007-12 (the period at issue).

Claims re Personal Expenditures

- Zutrau challenged approximately $50K of credit card charges over a 6-year period as being personal expenses, during which company charged over $1M to its credit card. Zutrau also challenged Jansing's use of credit card "rewards points" for personal purposes.

- Court found that use of rewards points was a de minimis perk that did not cost the company anything and was not inconsistent with past practices or industry custom. Ruled in Jansing's favor.

- Court ultimately found that approximately $22K of the challenged credit card charges were for personal expenses, or that Jansing had not met burden of proving otherwise. Ruled in Zutrau's favor on this amount. Note that there must be some basis other than speculation to shift burden.

- Court further ruled that there were an additional $10K in personal expenditures. Ruled in Zutrau's favor on this amount., but rejected claim for an additional $12K.

Claim re Failure to Replace Zutrau

- Ruled in Jansing's favor.

- Jansing's decision not to replace Zutrau or appoint new treasurer entitled to presumption of business judgment rule.

- "Zutrau's claim that Jansing failed to replace her with people competent to provide oversight in order to facilitate his own self-dealing fails, as a matter of fact and law, because Zutrau—who was a minority stockholder and officer, but not a director of ICE, like Jansing—never had the authority to oversee or prevent the few instances of inappropriate self-dealing by Jansing that she has proven."

Claims Challenging Reverse Stock Split

- 'Zutrau challenged the Reverse Stock Split on two principal grounds. First, she argued that Jansing effected the Reverse Stock Split for the sole purpose of depriving her of standing to pursue her derivative claims, in breach of his fiduciary duties. Second, she contended that she received inadequate consideration for her fractional shares, in breach of Jansing's fiduciary duties as well as the —fair value|| requirement of Section 155. By way of relief as to both grounds, Zutrau seeks to have the Reverse Stock Split rescinded and to be reinstated as an ICE stockholder.'
- Reverse Stock Split by controlling stockholder subject to entire fairness review.
- Court found that depriving Zutrau of derivative standing was not a primary motivation for the Reverse Stock Split. Jansing had credible business justification for Reverse Stock Split; "the primary purpose of the Reverse Stock Split was to bring an end to the turbulent relationship between the parties and to allow both of them and the Company to move on." "[A]lthough the timing of the Reverse Stock Split on its face [was] suspicious, the process that led to it began before the filing of this action." "[W]hile Jansing previously has argued that Zutrau lacks standing to assert her derivative claims independently of the other claims in this action, he consistently has stated that he has no objection to Zutrau effectively litigating her derivative claims for purposes of valuing her interest in ICE in connection with the Reverse Stock Split."
- Court found that Reverse Stock Split was not the product of fair dealing, because there was no independent committee or anyone to bargain on behalf of or with the minority stockholder, Zutrau.
- Court relied on Duff & Phelps' $2.2M valuation of ICE as baseline. Concurred that DCF is appropriate method for valuing company. "Although ICE is an S corporation, and such corporations are not taxed at the entity level, Duff & Phelps, following this Court's practice in *Delaware Open MRI Radiology Associates, P.A. v. Kessler*, estimated an equivalent, hypothetical pre-dividend S corporation tax rate of 28.8 percent, which it applied to ICE's projected operating cash flows."

Effect of Fiduciary Breaches on Valuation

- Court found that Duff & Phelps valuation did not adequately capture fair value at time of Reverse Stock Split because it did not account for breaches of fiduciary duties.

- Jansing proposed that Zutrau should be awarded pro rata share of value of any derivative claims. Court rejects this.

- Court found that value of derivative claims, totaling approximately $500K plus interest, must be added to valuation as a non-operating asset.

- Court required adjustment to cash flow projections used by Duff & Phelps for valuation to reduce payroll expenses in order to compensate for excessive compensation found by Court.

- Court rejected Zutrau's expert's analysis, with valuations as high as $20M for the company, as being based on speculative and unjustified assumptions.

Remedy

- Court found fair value plus interest is the appropriate remedy. Although Reverse Stock Split was self-dealing and accomplished at an unfair price, it was based on a largely independent valuation, was not accomplished for the purpose of depriving Zutrau of her derivative standing, and was the result of deliberate misconduct, fraud or gross and palpable overreaching.

- Court required recalculation by Duff & Phelps. [Subsequent recalculation by Duff & Phelps increased Zutrau's share from $495K to **$876K** (including interest).]

- Court rejected Zutrau's claims for rescission of the Reverse Stock Split and dissolution of the company. Because Reverse Stock Split stood, Zutrau lacked standing to seek dissolution. Moreover, extreme remedy of dissolution unavailable for this solvent company.

- Court rejected Jansing's counterclaim that $60K awarded by NY court as remaining in Zutrau's capital account is included in Duff & Phelps valuation, not on the merits, but on collateral estoppel grounds.

- Court awarded costs to Zutrau.