

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

CANMORE CONSULTANTS LTD.,)
MIRAGE CAPITAL INC., RALPH E.)
WOLOSCHUK, MARGARET)
WOLOSCHUK and RONALD)
ROTELIUK,)

Plaintiffs,)

v.)

Civil Action No. 8645-VCG

L.O.M. MEDICAL INTERNATIONAL,)
INC., ALAN J. LAWRENCE, and)
CHARLES L. CLEMENTS,)

Defendants.)

OPINION

Date Submitted: September 4, 2013

Date Decided: September 19, 2013

Charles Brown, Michael Busenkell and Brya Keilson, of Gellert Scali Busenkell & Brown, LLC, Attorneys for Plaintiffs.

Paul D. Brown and Joseph B. Cicero, of Cousins Chipman & Brown LLP, Attorneys for Defendants.

GLASSCOCK, Vice Chancellor

This matter is the first case to turn on the sole application of 8 *Del. C.* § 223(c). That statute allows stockholders in certain limited circumstances to petition—but not compel—this Court to direct that a special stockholder’s meeting take place to fill vacancies on the corporate board through exercise of the stockholders’ franchise, rather than through appointment by the remaining directors. The Plaintiffs here fulfill the statutory requirements for standing to make such a request. The statute commits the decision whether to grant a petition under Section 223(c) to the discretion of the Court, but is silent as to how that discretion is to be exercised, presenting a simple but until now unanswered question: which party bears the burden of persuasion under Section 223(c)? I find in this Opinion that that burden is borne appropriately by the Plaintiffs. Under the facts presented here, I find that the equities do not support a special meeting of the stockholders, and that the directors appointed by the remaining elected directors should continue in office until the next annual meeting, at which time they will be subject to the will of the stockholders expressed at that election.

I. BACKGROUND

A. The Gentili Action

This action is a sequel to another action before this Court, *Gentili v. L.O.M. Medical Int., Inc.* In that action, twenty-three plaintiffs representing the interests of a stockholder faction known as the “Gentili group,” which included current

directors of L.O.M. Medical International, Inc. (“L.O.M.”) Alan Lawrence and Randy Hayward, sought under 8 *Del. C.* § 225 to challenge the validity of incumbent directorships elected at the company’s annual meeting held on April 17, 2012. At that meeting then-incumbent directors Ralph Woloschuk, Ronald Roteliuk, Carolyn Wallace, Ian Mavety, and Charles LaPointe (the “Incumbent Directors”) accepted votes in favor of their election after the company’s President had prematurely adjourned the meeting. I denied the Incumbent Directors’ motion to dismiss in a Letter Opinion dated August 17, 2012, noting that:

“It appears to me that the Defendants have two courses of action open to them here: (1) they can answer the Complaint and we can go forward, on a schedule appropriate to a summary proceeding, to a hearing on the validity of the adjournment, and the attempt to override that adjournment, of the meeting held on April 17, 2012, or (2) in the alternative, the Defendants can seek a new stockholders’ meeting, done under the supervision of this Court, with appropriate safeguards in place to ensure that the meeting does not adjourn for improper reasons.”¹

The Incumbent Directors opted for the latter, and the parties stipulated to holding a second stockholders’ meeting, to be overseen by Special Master John Mark Zeberkiewicz acting as Chairman at the meeting.²

B. The Loan

¹ *Gentili v. L.O.M. Medical Int., Inc.*, 2012 WL 3552685, at *3 (Del. Ch. August 17, 2012).

² *Gentili v. L.O.M. Medical Int., Inc.*, No. 7600-VCG (Del. Ch. Jan. 31, 2013) (ORDER).

On July 13, 2012, during the pendency of the Section 225 matter, I entered a status quo order which prevented the company from taking any material action out of the ordinary course of business.³ On January 17, 2013, the Incumbent Directors filed a Loan Notice indicating the L.O.M. board's intention to enter into a loan agreement with director and current-Plaintiff Ralph Woloschuk, whereby Woloschuk would loan the company \$200,000 under "commercially reasonable terms." The Gentili group objected to the loan, and I held a hearing resulting in my Order of March 26, 2013, approving the loan based on representations that the company had insufficient funds to pay costs associated with holding the March election.⁴ Although the draft budget submitted with the application indicated that the loan would be used to pay meeting expenses, including payment to the Special Master, L.O.M.'s board allocated \$100,000 of the loan to US legal fees and \$100,000 to Canadian legal fees. That misallocation is the subject of a pending Motion for Contempt in the *Gentili* action.

C. The Election

In accordance with the Court's January 31, 2013 Order, the company held a new meeting on March 18, 2013. Proxy materials provided stockholders the opportunity to (1) elect five directors to serve on the company's board of directors until the company's next annual meeting, and (2) ratify, confirm and approve the

³ *Gentili v. L.O.M. Medical Int., Inc.*, No. 7600-VCG (Del. Ch. July 13, 2012) (ORDER).

⁴ *Gentili v. L.O.M. Medical Int., Inc.*, No. 7600-VCG (Del. Ch. March 26, 2013) (ORDER).

company's 2012 Stock Option Plan. The vote resulted in the election of Carolyn Wallace, Charles Clements, Lyle Bauer, Alan Lawrence, and Revett Eldred to the company's board of directors, and in the rejection of the 2012 Stock Option Plan.

D. Director Resignations and Appointments

On March 18, 2013, as discussed above, five directors were elected to L.O.M.'s board. Two months later, on May 28, 2013, two of those directors, Lyle Bauer and Revett Eldred, resigned from their directorships. Bauer cited insufficient indemnification and liability insurance as his reason for resigning,⁵ while Eldred simply stated that the board "[was] aware of [his] reasons for resigning."⁶ In preparation for appointing at least one replacement director, Clements met with Herbert Towing, who executed a consent to serve. Before the Towing directorship could be placed before the board, Carolyn Wallace also resigned—without stating her reason for so doing—in the early morning hours of June 13, 2013, leaving only two elected directors in office.⁷ That same afternoon, the remaining directors, Charles Clements and Alan Lawrence—who, notably, did not comprise a majority of the whole board—executed written consents appointing Towing to the board. On June 30, 2013, the three directors appointed Randy

⁵ Def.'s Mot. for Summ. J., Ex. 30.

⁶ Def.'s Mot. for Summ. J., Ex. 31.

⁷ Def.'s Mot. for Summ. J., Ex. 34.

Hayward to fill one of the two remaining vacancies, and on July 18, 2013, the directors appointed Kenneth Powell to fill the final vacancy.

E. The Private Placement

After Towning, but before Hayward or Powell, joined L.O.M.'s board of directors, the company approved a private placement that raised \$544,250 from twenty-one investors. That capital, however, was insufficient to cover the company's liabilities, which still include the debts incurred in holding the March 18, 2013 stockholder meeting.

II. ANALYSIS

This case comes before me on the Defendants' Motion for Summary Judgment. The Plaintiffs have not so moved, but at oral argument agreed that, in the interest of vindicating the "summary" nature of the proceeding, I should decide the question of whether to order a new election on the limited set of facts before me. 8 *Del. C.* § 223 provides that:

(a) Unless otherwise provided in the certificate of incorporation or bylaws:

(1) Vacancies and newly created directorships resulting from any increase in the authorized number of directors elected by all of the stockholders having the right to vote as a single class may be filled by a majority of the directors then in office, although less than a quorum, or by a sole remaining director

. . . .

(c) If, at the time of filling any vacancy . . . the directors then in office shall constitute less than a majority of the whole board . . . the Court of Chancery may, upon application of any stockholder or stockholders

holding at least 10 percent of the voting stock at the time outstanding having the right to vote for such directors, summarily order an election to be held to fill any such vacancies or newly created directorships, or to replace the directors chosen by the directors then in office as aforesaid, which election shall be governed by § 211 or § 215 of this title as far as applicable.

The parties agree that the Plaintiffs have standing to bring this action, since (1) collectively they hold at least ten percent of the voting stock, and (2) after Wallace resigned from the board, only two of five directors—a minority—remained. The Plaintiffs understand Section 223(c)'s grant of authority to hear this case as creating a presumption in favor of ordering an election, and thus argue that, having satisfied the standing requirements, they are entitled to a new election, or that at the very least, the equities should be construed as favoring an election. However, I disagree with this understanding of Section 223(c), which I view as providing only a limited exception to Section 223(a)'s grant of director authority to fill board vacancies. The presumption for which the Plaintiffs advocate is not reflected in the language or purpose of the statute; accordingly, more than satisfaction of the statutory standing requirements must be shown in order for the Plaintiffs to prevail.

Section 223(c) is permissive. Upon application, the Court *may* exercise its discretion to order an election under these circumstances; the appropriate inquiry at this time, therefore, is whether it *should*. The statute does not point to any factors as controlling in this exercise of discretion, and I am therefore free to weigh the equities as they exist in the particular factual situation presented. Common to all

cases under Section 223(c) is the clear interest that the statute represents: that the stockholders have the right to select directors through exercise of their voting franchise. Historically, newly elected directorships were filled by stockholder vote,⁸ and in the absence of a majority of elected directors, vacancies could likewise only be filled through exercise of this franchise.⁹ The DGCL has modified the law to allow the representatives of the stockholders—the elected directors—to fill both newly created directorships and vacancies created between yearly meetings, saving the expense and distraction of special meetings between annual meetings for purposes of filling board vacancies.¹⁰ The purpose of Section 223(c), then, is to limit Section 223(a)’s grant of director authority by allowing Court intervention to prevent a minority of elected directors from appointing a majority of the board, where the holders of at least ten percent of the shares outstanding request a vote, and where the equities in favor of postponing such a vote until the next annual meeting do not outweigh the interests of the stockholders

⁸ See *Moon v. Moon Motor Car Co.*, 151 A. 298, 302 (Del. Ch. 1930) (stating that the power to fill newly created directorships “resides inherently in the stockholders”); 1 R. Franklin Balotti & Jesse A. Finkelstein, *Del. L. of Corp. and Bus. Org.* § 4.5 (“Prior to the 1949 Amendment of the predecessor to Section 223, only stockholders could fill a vacancy on the board resulting from a newly created seat.”).

⁹ See 1 R. Franklin Balotti & Jesse A. Finkelstein, *Del. L. of Corp. and Bus. Org.* § 4.5 (2013) (explaining that “[p]rior to the 1927 Amendment of the predecessor to Section 223, vacancies on the board could be filled only when a majority of the entire board was present for voting purposes.”); 1 Edward P. Welch, Andrew J. Turezyn & Robert S. Saunders, *Folk on the Del. Gen. Corp. L.* § 223.2 (2008) (“Since the power to fill vacancies ‘resides inherently in the stockholders,’ the permissive language of Section 223(a) ‘does not prevent the stockholders from filling the new directorships’ or other vacancies.”).

¹⁰ See *id.* at § 223.4 (“Section 223 has been progressively amended to enlarge the powers of directors to fill vacancies.”).

in an immediate exercise of their voting franchise. Thus, Sections 223(a) and (c) create a balance between efficiency and cost-saving on the one hand, and the preservation of the stockholder franchise and of limits on director authority, on the other.¹¹

As I emphasized above, however, I view Section 223(c) as providing only a *limited* exception to the directorial authority to fill vacancies granted under Section 223(a). My determination that Section 223(c) provides only a modest constraint on directorial authority is reinforced by the additional caveat in Section 223(a) that directors may fill board vacancies only where doing so is not prohibited by a company's certificate of incorporation or bylaws.¹² Because a company has the ability to entirely eliminate the authority granted to directors under 223(a), the utility of 223(c) to constrain directorial authority is minimal; Section 223(c) merely creates a narrow avenue whereby the Court may prevent directors from filling board vacancies where doing so is necessary to avoid some identifiable inequity. Thus, while directors may and usually do fill board vacancies as they occur, Section 223(c) provides stockholders the opportunity, in the *limited* instance

¹¹ See 1 R. Franklin Balotti & Jesse A. Finkelstein, Del. L. of Corp. and Bus. Org. § 4.5 (2013) (“The permissive language of current Section 223(a), considered in connection with the power of the stockholders to elect directors, means that the power to fill vacancies is shared between the directors and the stockholders.”).

¹² See 8 Del. C. § 223(a) (“Unless otherwise provided in the certificate of incorporation or bylaws: (1) Vacancies and newly created directorships resulting from any increase in the authorized number of directors elected by all of the stockholders having the right to vote as a single class may be filled by a majority of the directors then in office, although less than a quorum, or by a sole remaining director . . .”).

circumscribed by the subsection, to demonstrate that the particular equities of the case weigh in favor of divesting directors of that power and justify the expense and distraction of holding a special stockholder meeting to fill those vacancies instead.¹³

Reading the statute in the context of these purposes, I understand Section 223(c) to place the burden to demonstrate that the equities weigh in favor of ordering an election on the Plaintiffs requesting the election. That is, when a corporation chooses to forgo a provision in its certificate of incorporation or bylaws restricting the directors' ability to fill board vacancies as authorized in Section 223(a), as the company here has so chosen, I understand Section 223(c) to permit the Plaintiffs under the current circumstances to request a new election to fill vacancies, but to place on them the burden to demonstrate that the equities require such an election.¹⁴

The Defendants point to a single case exercising the permissive authority to order a new election now embodied in Section 223(c). In *McWhirter v. Washington Royalties Co.*, decided in 1930, four directors of a seven-member

¹³ See *McWhirter v. Washington Royalties Co.*, 152 A.220, 249 (Del. Ch. 1930) (explaining that Section 30, the predecessor of § 223, contemplated that “the stockholders, if ten per cent. request it, have a *right to request* that they be convened in meeting and afforded the opportunity of saying whether they desire the persons so chosen by a minority of their own agents to continue as the dominant managers of their corporate affairs”) (emphasis added).

¹⁴ I would note, however, that consistent with *McWhirter*, discussed *infra*, as the percentage of stockholders supporting a new election approaches a majority, this itself may become an equitable factor supporting an election.

board resigned, leaving three directors to fill their vacancies.¹⁵ Following the resignations, 225 of 621 stockholders—constituting forty-three percent of the company—petitioned the Court for a new election to fill the vacancies. The Court held that the support of forty-three percent of the stockholders was prima facie evidence that such an election was appropriate, and accordingly ordered a new election, despite the annual election being only three months away.¹⁶ In one other case, *Prickett v. American Steel & Pump Corp.*, the Court ordered an election under Section 223(c), but in circumstances where an annual meeting had not been held the previous year, in violation of 8 *Del. C.* § 211(b).¹⁷ It was a fortuity that the plaintiffs in that case had standing to bring the claim under both Sections 223(c) and 211(b).

Here, the Plaintiffs' stake in the company, although exceeding the ten percent required to confer standing under Section 223(c), does not approach the near majority that requested an election in *McWhirter*. And unlike *Prickett*, an election has been held within the last year. Thus, neither case sheds much light on the current situation, and the parties rely on other equitable considerations in arguing whether or not an election should be held.

¹⁵ *McWhirter v. Washington Royalties Co.*, 152 A.220, 249 (Del. Ch. 1930).

¹⁶ *Id.* (“Where such a large percentage makes the request, that in itself is enough, in the absence of some strong showing contra, to prompt me to exercise my discretion in a favorable way, where as here the annual meeting is three months distant.”).

¹⁷ *Prickett v. Am. Steel & Pump Corp.*, 251 A.2d 576 (Del. Ch. 1969).

The Defendants argue that the facts before me militate against ordering a new meeting. They argue that Plaintiffs Woloschuk and Roteliuk, having lost the March election, are essentially using this litigation as a “do-over,” and that, having already held two stockholder meetings in the last year and a half, and having failed as yet to generate income, the company does not have sufficient assets to pay its debts from the last election held six months ago, let alone to hold a new meeting now. This assertion is supported in the record.¹⁸ The Defendants also note that the period of time during which less than a majority of board seats were filled lasted less than one day; that the current board has already filled the vacancies in accordance with the company’s bylaws; and that those new directors are independent and therefore not “embroiled in the panoply of litigation that has sapped this development-stage company’s time, attention and resources for years.”¹⁹ Finally, the Defendants remind the Court that the company’s annual election is only six months away.

The Plaintiffs argue, on the other hand, that the Court should order a new election, suggesting that stockholder interests are divided such that permitting the

¹⁸ See Aff. of Charles L. Clements at 3-5 (explaining that that revenue generated by the private placement was insufficient to satisfy all of the company’s debts); Aff. of Alan J. Lawrence at 3 (detailing the company’s indemnification expenses and describing the company as “short on funds”). The Plaintiffs argue that, had the board elected on March 18 followed the then-Incumbent Directors’ plan to raise capital, the company would not be in its current financial situation. However, the contention that the Plaintiffs had a different, or even better, plan to raise capital than the current board does not contradict the fact that the company currently has more expenses than assets.

¹⁹ Def.’s Br. in Supp. of Mot. for Summ. J. at 2.

remaining directors to fill the vacancies would deprive a faction of the stockholders of representation. In particular, the Plaintiffs speculate that the recent private placement was offered only to allies of the Gentili group in an attempt for that group to secure control of the company. Additionally, as a matter of statutory interpretation, the Plaintiffs argue that, despite the authority granted to directors to fill vacancies under Section 223(a), failing to order a new election would “deprive shareholders of L.O.M. of their fundamental right to vote and elect directors”²⁰

In weighing these prudential factors, I first note that the parties before me have participated in this struggle for control since April 2012. Because the Incumbent Directors in the *Gentili* action prematurely adjourned the April 17, 2012 meeting, I ordered that another stockholder meeting be held in March 2013. The Incumbent Directors were largely rejected by the stockholders at that meeting, and there is no indication that the outcome of a new election would be any different. I also note that, had Wallace not resigned her directorship on June 13, 2013, Lawrence and Clements, constituting a majority of the board, would have had the authority under the company’s bylaws to appoint Towing to fill a board vacancy, even if Wallace had voted against that appointment. Thus, the Plaintiffs’ standing to bring this action arises from simple fortuity.

²⁰ Pl.’s Answering Br. in Opp’n to Mot. for Summ. J. at 16.

Unpersuasive to me here is the Defendants' argument that I should not order a new election because the company's next annual election will be held in only six months. If Section 223(c) is to have any application at all, it must not prevent ordering a new meeting where the annual meeting is half a year hence; it is always the case that the next election will occur in less than one year, and Section 223(c) permits stockholders to petition for an election to be held notwithstanding that fact. While it may be the case that in some instances the next annual election will be so near as to render a Section 223(c) claim moot, that is not the case here, and I would note that the Court in *McWhirter* ordered a new election even though the next annual election was only three months distant.²¹

Nor does the Plaintiffs' speculation regarding the Defendants' selective choice of investors for the private placement enter into my equitable calculation. Despite admitting that they do not even know to whom the private placement was offered, the Plaintiffs argue that they suspect the placement was offered only to allies of the Gentili group in an effort to bolster stockholder support before the next election, and that this suspicion, although devoid of factual support, should weigh in favor of ordering a new election. To alleviate that suspicion, counsel for the Defendants represented that their clients would likely permit the Plaintiffs to participate in a second private placement on similar terms. More pertinent to my

²¹ *McWhirter v. Washington Royalties Co.*, 152 A.220, 251 (Del. Ch. 1930).

analysis, though, is that, even if some wrongdoing did occur with respect to the private placement, a new election would not remedy that wrong, since the private placement shares would be entitled to vote in a new election. Instead, if the Plaintiffs believe there is merit to this claim, their remedy is to file a separate action seeking sterilization of the private placement shares before the annual election. And finally, as discussed in detail above, I reject the Plaintiffs' argument that Section 223(c)'s permissive grant of authority to hear this claim carries a presumption in favor of ordering a new election.

Ultimately, the dispositive problem with ordering a new stockholder meeting in this instance is that the company lacks the necessary funds to hold another meeting. Under a March 26, 2013 Order, I permitted the company to enter into a loan agreement to borrow \$200,000, based on representations that the company did not have sufficient funds to pay expenses associated with the March 18 stockholder meeting.²² Those funds were then paid to US and Canadian legal counsel, while the Special Master and other expenses resulting from the March 18 meeting have still not been paid. The Defendants now inform me that a recent private placement raised \$544,250, but that even that infusion of capital was insufficient to cover

²² This loan is the subject of a pending Motion for Contempt in the *Gentili* action. The Defendants argue that, because Plaintiffs Woloschuk and Roteliuk, as defendants in the *Gentili* action, did not comply with the draft budget appended to the proposed order in spending the proceeds of the loan, such inequitable conduct renders their hands unclean and I should therefore refuse to order a new election. However, because the equities exclusive of the unclean hands issue weigh against ordering a new election, I need not consider whether the Defendants' unclean hands argument has merit here.

both the March meeting expenses and the company's other expenses. Since I am without a reasonable ground to believe that the company could raise the funds to pay its current debts, and then raise additional funds to hold a new meeting, and because the Plaintiffs can point to no persuasive equitable reason why stockholder interests are not protected by the current board, I cannot find that the equities favor ordering a new election to fill the board vacancies.²³ I note that the stockholders recently rejected a slate of directors associated with the Plaintiffs here; therefore, I do not find that a significant diminution of the stockholders' voting rights will occur if the current board is allowed to remain under authority of Section 223(a). The Plaintiffs have failed to demonstrate that the equities require forcing the cash-strapped company to repeat the same struggle for control that the stockholders have so recently addressed.

III. CONCLUSION

In circumstances where only a minority of board positions are occupied and vacancies must be filled, 8 *Del. C.* § 223(c) provides to stockholders owning at least ten percent of a company the right to argue before this Court that the equities favor ordering a new election to allow the stockholders to fill the vacancies themselves. In order to perfect the right to a special election under Section 223(c),

²³ The Plaintiffs suggest that, if a new election were held electronically, the expenses associated with holding a new meeting would be minimal. The Defendants are correct to point out, however, that even a meeting held electronically generates legal fees, fees related to proxy preparation and solicitation, and fees paid to an Inspector of Elections. Or. Arg. Tr. at 9.

the Plaintiffs must show (1) that only a minority of directors remained on the board at the pertinent time, (2) that the Plaintiffs represent at least ten percent of outstanding shares, and (3) that the equities support their request. Here, the Plaintiffs have failed to satisfy this last burden. I therefore grant the Defendants' Motion for Summary Judgment, and refrain from ordering a new election to fill the vacancies on L.O.M.'s board. The parties should submit an appropriate order.