Disclosure Obligations for Stockholder Notices

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When venture backed companies require the consent of their stockholders, it is common practice to obtain this consent through a written consent of stockholders rather than by convening a meeting. When a corporation elects to take corporate action by written consent in lieu of a meeting, Section 228 of Delaware's General Corporation Law requires corporations to provide "prompt notice" of corporate action to those stockholders who have not consented in writing to such action. However, the Delaware statute does not affirmatively require a corporation to include in the notice substantive information or lengthy disclosure related to the action taken by the corporation. Based upon a recent Delaware decision that examines the approval process of a recapitalization transaction, this practice may change. This development is likely to be of particular relevance to recapitalization transactions, including a recapitalization that may be undertaken as part of a down round financing.

In *Dubroff v. Wren Holdings, LLC, Del. Ch., C.A.* No. 3940-VCN (May 22, 2009), the plaintiffs alleged, among other claims, a breach of fiduciary duty due to the failure to disclose appropriate, relevant information to stockholders in a Section 228 Notice related to a recapitalization of the corporation approved by stockholder written consent. The corporation had effected a recapitalization, including (i) the conversion of debt held by the defendants into convertible preferred stock of the corporation and (ii) a 1-for-20 reverse common stock split. Although the notice to stockholders referenced the reverse common stock split and the exchange of debt for preferred stock, it failed to disclose the fact that the defendants — who had approved the recapitalization as majority stockholders — benefited as a result of the recapitalization (the defen- dants equity ownership increased from approximately 56% to 80%). In addition, the notice did not reference the price at which the defendants' debt converted to convertible preferred stock. The plaintiffs claimed that if the notice had contained full disclosure, the plaintiffs could have made a claim for rescissionary relief.

The Court of Chancery recognized the fact that to date Delaware case law has not yet addressed the issue of whether Section 228 notices require full disclosure similar to disclosure required when soliciting stockholder approval. However, the Court determined that material facts were omitted from the notice and found that

> "there are well-plead facts in the Complaint sufficient for the Court to infer reasonably that the board deliberately omitted material information with the goal of misleading the Plaintiffs and other shareholders about the Defendants' material financial interest in, and benefit conferred by, the Recapitalization not shared with other shareholders."

The Court denied the defendants' motion to dismiss and concluded that the plaintiffs have stated a claim for breach of fiduciary duty.

As a result of this case, corporations should consider including additional disclosure when distributing Section 228 notices to those stockholders who have not consented in writing.

For more information on disclosure obligations for stockholder notices, please contact **Mary Beth Kerrigan**.