IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

JOE JOHNSTON, DIETMAR ROSE, and DOUG HOLT, Plaintiffs, v. KEN PEDERSEN, ROBERT CLIFFORD, JAY MCGARRIGLE, RICHARD RYGG, JACK FISH, and XUREX, INC., a Delaware corporation, Defendants.	)	C.A. No. _____

MOTION TO MAINTAIN STATUS QUO

Plaintiffs Joe Johnston, Dietmar Rose, and Doug Holt ("Plaintiffs") hereby move this Court, under Court of Chancery Rule 65 and 8 *Del. C.* § 225 ("Section 225"), for an order in the form attached hereto as Exhibit A (the "Proposed Order") restraining and enjoining defendants Ken Pedersen, Robert Clifford, Jay McGarrigle, Richard Rygg, and Jack Fish (collectively, the "Individual Defendants") and defendant Xurex, Inc. ("Xurex" or the "Company," and together with the Individual Defendants, the "Defendants") from undertaking any of the actions set forth in the Proposed Order. The grounds for this motion are as follows:

FACTUAL BACKGROUND

As detailed in the Verified Complaint filed herewith, Plaintiffs have brought this action pursuant to Section 225, seeking a declaration that the written consents of the holders of a majority of the outstanding stock of Xurex removing the Individual Defendants, fixing the size of the Xurex board of directors at five, and electing Joe Johnston, Dietmar Rose, Carl

McCutcheon, Bill O'Brien, and Nate Hutchens (the "New Directors") as directors of Xurex were valid and effective.

On June 14, 2011, duly executed and valid stockholder written consents ("the Written Consents"), signed by Bo Gimvang, Joe Johnston, Tristram Jensvold, Richard Waters, and Gary Padjen individually and as proxyholders for the holders of 57% of the outstanding stock of Xurex, resolving to (i) remove the Individual Defendants; (ii) determine that Xurex shall have five directors; and (iii) electing the New Directors as Xurex's directors were delivered to the Company's principal place of business and to its registered agent in Delaware.

On information and belief, the Individual Defendants contest the validity of the Written Consents based on a purported class vote right (the "Class Voting Provision") of the Series B Preferred Stock of Xurex, $0.01 par value per share, ("Series B"). However, the Individual Defendants, in violation of their fiduciary duties, issued the Series B with the intent and purpose of entrenching themselves as Xurex directors and disenfranchising Xurex's other stockholders.[1] The Individual Defendants' entrenchment motives render the Class Voting Provision of the Series B invalid. Further, pursuant to the plain language of the Series B certificate of designation, the Class Vote Provision does not apply to actions by written consent or to the removal and election of directors.

Absent immediate relief from this Court, on information and belief, the Individual Defendants will continue to claim entitlement to seats on the Xurex board of directors (the "Board") and will refuse to acknowledge or recognize the New Directors as the full Board. As a

[1] Defendant Jack Fish did not join the Xurex Board until 2011 and therefore was not on the Board at the time the Series B was issued. Thus, the allegations regarding the improper motives for issuing the Series B do not apply to Mr. Fish.

result, the Company and its stockholders will suffer irreparable harm due to the confusion as to the Company's proper directors.

Consequently, the Individual Defendants must be enjoined from taking any action purportedly on behalf of Xurex outside of the ordinary course of business of the Company.

ARGUMENT

I. Plaintiffs Are Entitled To A Reasonable Status Quo Order Until The Court Determines The Validity Of The Written Consents.

It has been the consistent and longstanding practice of this Court to enter limited orders maintaining the status quo where a party claiming title to office, but subject to proceedings under Section 225, could act in such a way as to harm a corporation prior to the time the Court is able to declare finally the rights of the parties. *See, e.g.*, *Pfizer Inc. v. Oral Research Labs, Inc.*, C.A. No. 10026, at 2 (Del. Ch. June 30, 1988) (TRANSCRIPT). Accordingly, this Court has often entered status quo orders when there is a dispute regarding a company's rightful directors. *See, e.g.*, *Communications Tech. Cos., Inc. v. Pedersen*, C.A. No. 16771 (Del. Ch. Dec. 11, 1998) (ORDER); *Maniero v. Microbyx Corp.*, C.A. No. 14228 (Del. Ch. June 26, 1996) (ORDER); *Old Fashioned Enters., Inc. v. Popp*, C.A. No. 14826 (Del. Ch. Feb. 27, 1996) (ORDER).

An order maintaining the status quo, such as that sought here, would enable Xurex to continue functioning as normally as possible, thereby minimizing the damage to the Company's business and its stockholders. In this regard, this Court has recognized the unique considerations present in a Section 225 action and has concluded that litigants need not satisfy the prerequisites for a temporary restraining order in order to prevail on this motion:

> [I]n [Section] 225 actions we have not, in my experience, required a showing of irreparable damage. Rather, the tendency has been ... to recognize a dispute about office and to imply from that that the exercise of corporate power by one group or the other always risks being the exercise of power by an unauthorized party, since you haven't adjudicated who has the rights. And it is that risk, the risk

> that an unauthorized party will ultimately have power over corporate assets and processes, that is the risk that justifies some reasonable restrictions.

Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., C.A. No. 12150, at 27-28 (Del. Ch. July 9, 1991) (TRANSCRIPT).

The operations of Xurex will be destabilized by competing claims or uncertainty as to who are the lawful directors of the Company. In the face of this confusion, the entry by this Court of an order maintaining the status quo will permit Xurex to continue operations. Accordingly, if the Proposed Order is not entered, the Company may suffer severe and substantial damage and innocent employees or third parties may likewise be injured. Thus, this Court should enter the Proposed Order maintaining the status quo, pending the resolution by this Court of who are the lawful directors of Xurex.

II. The Individual Defendants Have No Legitimate Grounds On Which To Contest The Validity Of The Written Consents.

A. The Individual Defendants Violated Their Fiduciary Duties When Issuing The Series B, And Thus, The Class Voting Provision Does Not Render The Written Consents Ineffective.

The Individual Defendants had a variety of mechanisms available to secure funding for Xurex. The method they selected, issuing the Series B, which diluted existing stockholders, was specifically chosen to allow the Individual Defendants to cheaply acquire control of Xurex without alerting the current stockholders to their scheme. *See* Compl., Ex. D ¶¶ 5-8 (Affidavit of Rex A. Powers ("Powers Affidavit")). The Individuals Defendants accomplished this by issuing the Series B at a mere 10 cents per share. *See* Compl., Ex. C at 1 (Series B Offering Memo.). These cheaply priced shares contained the Class Voting Provision that the Individual Directors intended to operate as an absolute veto over any matter put to a stockholder vote. Incredibly, the Individual Defendants, when questioned whether the Class Voting Provision was fully disclosed

to existing stockholders, admitted that the only disclosure regarding this provision was buried in a vague and opaque description of the Series B in such a way that the existing stockholders would not understand the true nature of the provision. *See* Compl. at Ex. D ¶ 8. Understandably, existing stockholders were not eager to purchase shares at such a dilutive price; and, as intended by the Individual Defendants, stockholders apparently did not notice or understand the potential breadth of the Class Voting Provision.

The Individual Defendants' conduct was in breach of their fiduciary duties and violates numerous principles of Delaware law including those espoused in *Schnell, Blasius*, *Unocal*, and this Court's opinions regarding the duty of disclosure.

1. The Individual Defendants' Attempt To Disenfranchise Xurex's Stockholders Violates *Blasius* And *Schnell.*

It is well-established that a corporate board may not use the "the corporate machinery and the Delaware law for the purpose of perpetuating itself in office." *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971). Moreover, under *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988), a board that acts "for the primary purpose of impeding the exercise of stockholder voting power" must "demonstrat[e] a compelling justification" to sustain its actions. *Id.* at 661; *see also Williams v. Geier*, 671 A.2d 1368, 1376 (Del. 1996) (explaining that *Blasius* applies where the purpose of board action is "to interfere with or impede ... the shareholder franchise"). The test for whether a measure interferes impermissibly with the stockholder franchise is objective. *See Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1121 (Del. Ch. 1990) ("[f]iduciaries who are subjectively operating selflessly" may still violate *Blasius*); *Linton v. Everett*, 1997 WL 441189, at *9 (Del. Ch. July 31, 1997) ("it is not required that scienter, *i.e.*, actual subjective intent to impede the voting process, be shown").

In determining the primary purpose of a challenged board action, the Court may look beyond what the board has stated as its purpose when there is further evidence which demonstrates that the board's actual intent was to disenfranchise stockholders. *See Commonwealth Assoc. v. Providence Health Care, Inc.*, 1993 WL 432779, at *8 (Del. Ch. Oct. 22, 1993). In this action, there is ample evidence that the motives of the Individual Defendants were to entrenchment themselves cheaply and securely as directors and officers of Xurex. These motivations plainly violate the rule that corporate directors and officer may not use "the corporate machinery and the Delaware law for the purpose of perpetuating [themselves] in office." *Schnell*, 285 A.2d at 439. Indeed, while theoretically directors may authorize preferred stock that possesses extraordinary voting rights, directors may not do so to disenfranchise stockholders. *See Packer v. Yampol*, 1986 WL 4748, at *15-17 (Del. Ch. Apr. 18, 1986) (enjoining supermajority voting rights of preferred stock issued to defeat plaintiffs' proxy solicitation). Such disloyal behavior violates *Schnell* and falls demonstrably short of the "compelling justification" required by *Blasius* and its progeny. Thus, the Class Voting Provision, inserted into the Series B certificate of designation for the express purpose of disenfranchising any Xurex stockholders not affiliated with or friendly to the Individual Defendants, is *ultra vires* and is of no force or effect.

2. The Individuals Defendants' Issuance Of The Series B To Entrench Themselves Violates *Unocal.*

Under the rule of law set forth in *Unocal*, the directors must show that: (i) a defensive action was in response to a legally cognizable threat to the corporation; and (ii) that the defensive response was proportional to the threat. *See, e.g., Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985); *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1152 (Del.

1989). The defensive response is not proportional if it is either "preclusive" or "coercive." *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1388 (Del. 1995).

The Individual Defendants did not issue the Series B in response to an inadequately priced tender offer or as way to defeat any third party. *See* Compl., Ex. C at 12. Instead, the Series B's stated purpose was to raise capital to support continued development and marketing of the Company's products. *Id.* The Individual Defendants, though, had a variety of methods available to raise capital, and in fact had successfully raised capital in the past without offering a provision such as the Class Voting Provision. *Cf. Packer*, 1986 WL 4748, at *15 (rejecting directors' argument that raising capital required supermajority voting preferred). However, the Individuals Defendants did perceived a threat, not to corporate policy and effectiveness, but to their ability to maintain control of Xurex and continue as directors and officers of the company. *See* Compl., Ex. D ¶¶ 5-8. In response to this threat, the Individual Defendants disloyally conceived of and executed a scheme to issue the dilutive Series B and intentionally buried a vague reference to the Class Voting Provision in the Offering Memorandum. *See Id.*; Compl., Ex. C at 29. Thus, if the Court analyzes the Individual Defendants' entrenchment actions under *Unocal*, the Individual Defendants plainly violated their fiduciary duties because (i) there is no legally cognizable threat to Xurex to which the Class Voting Provision is a response; (ii) even if a threat is identified, selling a purported veto on all stockholder actions in an offering wherein there was no minimum offering amount (and in fact the Individual Defendants, in connection with other friendly investors, intended to be the majority holders of that series) is not proportional; and (iii) the Class Vote Provision is both preclusive (as the Individual Defendants contend that it applies to all stockholder actions) and inherently coercive; the only factor that limits the coercive nature of the Class Vote Provision was the Individual Defendants' intentional

violation of their duty of disclosure by burying the true effect of the provision in the Offering Memorandum. *See infra.*

3. The Individual Defendants Violated Their Duty Of Disclosure By Intentionally Obscuring The Class Voting Provision.

The Individual Defendants, as directors of a Delaware corporation, have a fiduciary duty to fully and fairly disclose all material information when seeking stockholder action. *Gantler v. Stephens*, 965 A.2d 695, 710 (Del. 2009). The test for materiality is whether there is a substantial likelihood that a reasonable investor would consider a fact important to their decision-making. *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1277 (Del. 1994). A disclosure is inadequate if relevant information is "buried" in stockholder materials. *See Blanchette v. Providence & Worcester Co.*, 428 F. Supp. 347, 353 (D. Del. 1977); *see also TCG Secs., Inc. v. S. Union Co.*, 1990 WL 7525, at *6 (Del. Ch. Jan. 31, 1990) (discussing the "buried facts" doctrine). An intentional violation of the duty of disclosure is a breach of the duty of loyalty. *See O'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 914-15 (Del. Ch. 1999); *see also Malone v. Brincat*, 722 A.2d 5, 11 (Del. 1998).

As noted above, the Individual Defendants did not want Xurex's stockholders to be aware of their plan to disloyally gain control of Xurex. *See* Compl., Ex. D ¶ 8. To this end, the sole description of the Class Voting Provision is a single opaque sentence on page 29 of the Offering Memorandum. The Individuals Defendants admitted that this solidarity and vague disclosure was designed so that stockholders would not be aware of the purported scope of the Class Voting Provision. *Id.* Such actions are plain violations of the Individual Defendants disclosure obligations. In addition, putting aside the Individual Defendants' subjective intent to inadequately describe the Series B, copying a single sentence for the Class Voting Provision (which is not a model of clear drafting), and placing it at the back of the Series B Offering

Memorandum, without elaboration, falls within the "buried facts" doctrine. *See Blanchette*, 428 F. Supp. at 353. Stockholders would unquestionably consider it important in deciding whether to participate in the Series B, or challenge the Individual Defendants' decision to offer the preferred stock, to know that the Individual Defendants interpret the Class Voting Provision as creating an effective veto over any and all stockholder votes (including the removal and election of directors). Thus, the failure to disclose the purported effect of the Class Voting Provision in a manner that highlights the potential sweeping reach of that provision was a breach of the duty of loyalty.

B. Under The Plain Language Of The Certificate of Designation, The Series B Is Not Entitled To A Class Vote Regarding Written Consents Removing And Electing Directors.

"The special rights and limitations of preferred stock are created by the corporate charter or a certificate of designation, which acts as an amendment to a certificate of incorporation." *Matulich v. Aegis Commc'ns Group, Inc.*, 942 A.2d 596, 600 (Del. 2008) (citation omitted). Any special voting rights granted the preferred stock must be expressed in clear and express language. *See Elliott Assocs., L.P. v. Avatex Corp.*, 715 A.2d 843, 852-53 (Del. 1998). Rights and preferences of preferred stock will not be inferred or assumed. *Id.* In addition, ambiguities in the certificate of designation will be construed against the drafter. *Id.* at 853.

The operative provision of the certificate of designation for the Series B states that the holders of a majority of the Series B, voting separately as a single class, "shall be required for the approval of any matter that is subject to a vote of the Corporation's stockholders, whether or not a class vote is required by law." *See* Compl., Ex. B at 4.b (Series B Certificate of Designation). However, a written consent is not a "matter that is subject to a vote" of the Company's stockholders. The Court in *Matulich v. Aegis Communications Group, Inc.*, 2007 WL 1662667 (Del. Ch. May 31, 2007), stated that:

> Indeed, the Delaware General Corporation Law specifically contemplates that a shareholder may be granted multiple methods by which they may express an opinion: "Each stockholder entitled to vote at a meeting of stockholders or to express consent or dissent to corporate action in writing without a meeting may authorize another person or persons to act for such stockholder by proxy...." **Thus, a shareholder may be entitled to "express consent or dissent" ... without possessing the right to vote.**

Id. at *6, *aff'd* 942 A.2d 596 (Del. 2008) (citation omitted and emphasis added). Thus, the Written Consents, authorized by a majority of the outstanding shares of Xurex, are an action undertaken by written consent and not by a stockholder vote. Therefore, the Class Voting Provision (to the extent it may be validly exercised at all) does not apply to the Written Consents.

Moreover, when stockholders act to elect or remove directors, such actions (whether authorized by written consent or otherwise), are not matters "subject to a vote of" the Company's stockholders. The Class Voting Provision, as a change to the default voting rights of the preferred stock, must be clear and express. *See Elliott Assocs., L.P.*, 715 A.2d at 852-53. The Class Voting Provision states that a class vote of the Series B is required for "the approval of" matters subject to vote the Company's stockholders. However, stockholders do not "approve" the election of directors; instead stockholders "approve" a corporation entering into, for example, a merger pursuant to 8 *Del. C.* § 251 or sale of all or substantially all of a corporation's assets pursuant to 8 *Del. C.* § 271. Thus, because directors are "elected" or "removed" as opposed to "approved" by stockholders, the Class Voting Provision cannot be applicable to the removal and election of directors.

WHEREFORE, Plaintiffs respectfully request that this Court enter immediately the Proposed Order attached hereto.

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