Stock transfer/Fraud

COURT OF CHANCERY
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RE: Edward S. Morente, III v. June F. Morente and Jacob Morente, C.A. No. 16763

Dear Counsel:

This opinion addresses the attempt by the plaintiff, Edward M. Morente, III ("Edward"), to obtain a judicial determination that he engaged in a "sham" transaction on September 20, 1990.[1] In that transaction, Edward executed and delivered a stock certificate to his son, defendant Jacob Morente ("Jacob"), certifying that Jacob was the owner of fifty shares of

[1] *See* Compl. ¶ 8.

Brandywine Flowers, Inc. Edward claims to have been the president, director, and sole owner of Brandywine Flowers at the time he signed and delivered the stock certificate to Jacob. The stock certificate was also signed by Edward's then-wife and Jacob's mother, defendant June F. Morente ("June"), as the treasurer and secretary of Brandywine Flowers. June was also the only other director of the company at that time.

Regrettably, during the years after the certificate transfer, the marital union of Edward and June was sundered. Apparently, their domestic difficulties spilled over into the operation of Brandywine Flowers.

As a result, over eight years after Edward transferred fifty shares to Jacob, Edward filed suit in this court seeking, among other things, a declaration that Jacob does not own the fifty shares. The basis for Edward's claim is that the transfer to Jacob was a fiction designed to help Jacob secure financing for the construction of a home by convincing lenders that Jacob owned valuable assets, when Jacob, in fact, did not. Once the sham's purpose had been served, Jacob, according to Edward, promised to give back or tear up the certificate but never did. Furthermore, Edward claims, Jacob gave no consideration for the transfer of the shares, even though Jacob

worked full-time for Brandywine Flowers and was being groomed by Edward to take over the business.*

This controversy has important corporate control implications. Brandywine Flowers has 250 authorized shares. The only shares any party claims were issued were the fifty issued to Edward in the 1960s (and over twenty-five of which June asserts ownership) and the fifty issued to Jacob in 1990 in the allegedly sham transaction. Thus the fifty shares transferred to Jacob equals half of the issued stock of the company.

Jacob hotly contests Edward's claims that the stock transfer was a sham and that he gave no consideration to Brandywine Flowers in exchange for the shares.[3] Jacob admits, however, that these questions raise a dispute of fact that must be resolved at trial.

Nonetheless, Jacob has brought a motion for summary judgment alleging that Edward's claim must be dismissed even if the stock transfer was a sham. Because Edward knowingly participated in the allegedly

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[2] Edward has testified to both those facts. Moreover, Edward has submitted as evidence a history of Brandywine Flowers. In that history, it states, among other things: "After returning from college in 1988, June and Ed's son, Jacob, started working full-time in the business office of the company. He concentrated on a strong use of computer applications and minimizing paper work. In 1990, Ed and June made Jacob a limited partner in the business." Defs. App. at B-2. The history appears to have been prepared for Brandywine Flower's customers, creditors, and suppliers.

[3] Jacob's mother June supports his view that the transfer was in all respects valid and proper

fraudulent stock transfer, he, according to Jacob, cannot now challenge it in this court. Under the equitable doctrines of acquiescence and unclean hands, Jacobs asserts, Edward is forbidden to seek the court's aid in disavowing the transaction.

Although the doctrinal basis for granting Jacob's motion is less than clear, I believe that a sound application of settled case law and equitable principles dictates dismissal of Edward's claim. In essence, Edward comes here asking this court to enforce Jacob's alleged promise to undo a fraudulent transaction once that transaction had accomplished its illicit purpose.

While Edward does claim that the transfer was infirm on technical grounds, the evidence he submitted in support of that argument is insubstantial. At the time of the transfer, Edward claims to have been the sole stockholder and president of Brandywine Flowers. He admits that he executed the certificate and gave it to Jacob.[4] He admits that Jacob has worked for Brandywine Flowers full-time for many years.[5] Yet Edward

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[4] *Testa v. Jarvis*, Del. Ch., C.A. No. 12847, mem. op., 1994 WL 30517, at *6, Allen, C. (Jan. 12, 1994) (possession of a stock certificate is strong evidence of ownership).

[5] *Id.* at *7 (service to the corporation, including that pre-dating the issuance of shares, is valid consideration for the issuance of corporate shares).

claims that the transfer was invalid because he himself failed to enter it on the company's stock ledger. But Edward admits that June and he comprised the board of directors of Brandywine Flowers in 1990. Therefore, they had the corporate authority to make the transfer that Edward concedes was made to Jacob, and Edward's failure to reflect the transfer in the company's stock ledger is but a makeweight defense!

But I need not and do not reach this issue. A venerable and unbroken line of cases starting with *Finch v. Warrior Cement Corp.* holds that "[a]cquiescence and participation in an issuance of stock, without consideration or for an insufficient consideration, will bar the right of the assenting stockholder to complain against its issuance."[7] This same doctrine prevents a party to the transfer from arguing that the transaction should be set aside for failure to comply with corporate formalities, such as a failure to secure formal approval by the board of directors.[8] The *Finch* line of cases

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[6] *Cf.* 8 Del. C. § 141(f).

[7] Del. Ch., 141 A. 54, 61 (1928); *see also Topkis v. Delaware Hardware Co.,* Del. Ch., *2* A.2d *114, 117 (1938); Bovay v. H.M. Byllesby & Co.,* Del. Ch., 22 A.2d 138, 141-42 (1941); Brown *v. Fenimore*, Del. Ch., C.A. No. *4097, 1977* WL 2566, at *3, Marvel, C. (Jan. 11, 1977); *Danvir Corp. v. Wahl*, Del. Ch., C.A. No. 8386, mem. op., 1987 WL 16507, at *4, Berger, V.C. (Sept. 8, 1987); *Testa*, 1994 WL 30517, at *8.

[8] *Danvir*, 1987 WL 10507, at *5

precludes Edward from challenging the validity of his own act in transferring fifty shares to Jacob.[9]

In so ruling, I reject Edward's argument that he cannot be said to have acquiesced in the original transaction because a material element of that transaction was Jacob's supposed agreement to rescind it once the sham had accomplished its illicit purpose. Edward is correct that acquiescence typically arises when a party complaining about a transaction has given the other party reason to believe that the transaction has been accepted by him.[10] At this stage, I must accept as true that Edward did not assent to Jacob's retention of the certificate because Jacob had agreed to return or destroy it once the sham had worked its magic.*' But I see no exception in the *Finch*

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[9] Edward argues that he cannot be estopped from challenging the transfer because Jacob could not have detrimentally relied on a transfer that Jacob (I must assume at this stage of the case) promised to undo. Because detrimental reliance is an element of equitable estoppel, *Burge* v. *Fidelity Bond & Mortgage Co.*, Del. Supr., 648 A.2d 4 14,420 (1994), and Jacob cannot satisfy that element, Edward contends that summary judgment cannot be granted. But then Vice Chancellor, now Justice, Berger dealt with precisely that argument in the *Dunvir* case and rejected it on the basis of the "time honored principle that, '[e]quity will not hear a complainant stultify himself by complaining against acts in which he participated ...'" *Danvir*, 1987 WL 16507, at *5 (*quoting Gottfieh v. McKee*, Del. Ch., 107 A.2d 240, 244 (1954)). Put another way, the rationale for this line of cases does not depend on a showing of detrimental reliance; it hinges on the fact that a plaintiff should not be permitted to participate knowingly in acts and then come into court to deny them later when it is to the plaintiffs personal advantage.

[10] Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery* §1 l-3, at 760 (1998).

[11] Jacob has not argued that Edward's decision to bring this suit eight years after the transfer constituted such a period of inactivity as to lead Jacob to believe that Edward had accepted the transfer as permanent and valid. *See id.*

line of cases that enables a participant in a stock transfer to challenge that transfer at a later time so long as the participant claims that the transferor and the transferee effected the transfer as a purposeful fraud on third parties. And the utility of creating an exception to a venerable and consistently applied doctrine for self-confessed frauds is not discernible.

Moreover, even if Edward is correct and he cannot be said to have "acquiesced" under *Finch* and its progeny, the doctrine of unclean hands bars relief for him. As former Vice Chancellor Brown well stated:

> [T]he purpose of the clean hands maxim is to protect the public and the court against misuse by one who, because of his conduct, has forfeited his right to have the court consider his claims, regardless of their merit.[12]

Here, Edward seeks to have this court enforce Jacob's alleged promise to rescind the "sham transaction" after that transaction had its intended improper effect. Thus Edward wants this court to believe that he — a person who has admitted to having been dishonest in connection with the stock transfer — is now telling the truth about the transfer — and to use the power entrusted it by the people of Delaware to compel specific performance of an aspect of an illegal contract.

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[12] *Skoglund v. Ormand Industries, Inc.*, Del. Ch., 372 A.2d 204, 213 (1976)

The unclean hands doctrine is a flexible one, which will not lightly be invoked when the party asserting the defense was not the victim of the plaintiffs inequitable behavior.[13] But, at bottom, the unclean hands doctrine is a "rule of public policy" and "not a matter of defense to be applied on behalf of a litigant[.]"[14] This court has the latitude to apply the doctrine to avoid becoming complicit in a plaintiffs fraudulent act.[15] That flexibility is appropriately used here to bar Edward from seeking to enforce Jacob's alleged promise to return the shares?

This is so even though this approach dictates the entry of judgment on Jacob's counterclaim seeking a declaration that the transfer was valid.

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[13] *Nakahara v. NS 1991 American Trust,* Del. Ch., 718 A.2d 5 18, 523 (1998). Although there are statements in case law that state this proposition in stronger terms, see, e.g., *Bodley* v. *Jones,* Del. Supr., 59 A.2d 463,470 (1947), I do not read that case law as denying me the flexibility to apply the doctrine to avoid implicating the court in a party's improper behavior.

[14] *Skoglund*, *372* A.2d at 2 13; *Nakahara, 7 18* A.2d at 522.

[15] See *Nakahara, 7* 18 A.2d at 522-23 (Delaware courts have wide latitude to apply the unclean hands doctrine where necessary to serve the doctrine's core purpose); see *also Bishop v. Bishop, 257* F.2d 495, 500 (3d. Cir. 1958) (unclean hands doctrine is flexible and properly used to bar relief to a litigant who committed fraud so as to aid her ex-husband in placing assets outside the reach of another of the ex-husband's former wives), *cert. denied, 359* U.S. 914 (1959).

[16] The case of *Derickson v. Derickson*, Del. Supr., 28 1 A.2d 487 (197 1), supports this conclusion. In that case, Horace Derickson sought to undo a transaction in which title to certain land was placed in the name of Horace's brother Allen Derickson so as to keep Horace's creditors from placing a lien on the land. The Chancery Court later granted Horace's request to impose an equitable trust for his benefit upon a half-interest in the land. The Supreme Court reversed, stating that "where a debtor purchases property which he causes to be conveyed to another for the purpose of hindering and delaying creditors, he has unclean hands and is not entitled to relief in a court of **equity."** *Id.* **at** 488.

Assuming (for purposes of this motion only) that Edward and Jacob are equally blameworthy as co-conspirators in a fraudulent transfer, equity has a simple answer to the problem: the court will leave the parties where it finds them.[17]

This is sensible public policy. Under this rule, a person thinking about entering into a fraudulent transaction knows that he will be at the mercy of his co-conspirator and unable to call upon the aid of the court. Thus he should think twice before acting dishonestly and making himself vulnerable to other persons with a professed willingness to engage in deception. But when he does not, goes on to commit fraud, and later feels aggrieved when one of his co-conspirators does not live up to her end of an illicit bargain, public resources should not be expended and the integrity of our courts should not be sullied in proceedings analogous to enforcing the code of "honor among thieves."[18]

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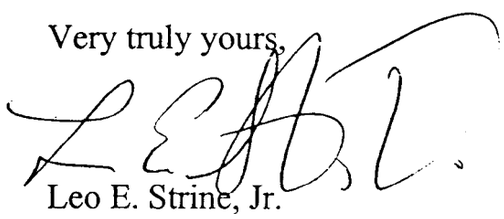
[17] *Morford v. Bellanca Aircraft Corp.*, Del. Super., *67* A.2d *542, 547 (1949); Bishop, 257* F.2d at *501*. I reject the argument that Edward, the older and supposedly wiser of the co-conspirators, was somehow less culpable than his then mid-twenty-something son Jacob. Indeed, Edward has admitted that the sham may have been his own idea.

[18] *Bishop,* 257 F.2d at 500 (court of equity will refuse "to be the abettor of iniquity" and will require applicants for relief to "have acted fairly and without fraud or deceit as to the controversy in issue") (citations and quotations omitted).

For all the foregoing reasons, Jacob's motion for summary judgment is granted, and he is declared to be the owner of fifty shares of the company's stock. IT IS SO ORDERED.

Very truly yours,



Leo E. Strine, Jr.

cc: Neil J. Levitsky, Esquire
oc: Register in Chancery