

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK : I.A.S. PART 3

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CHVP FOUNDERS FUND I, L.P., f/k/a CHVP
FOUNDERS EXCHANGE FUND, L.P.,

Index No. 601200/2006

Plaintiff,

- against -

ARBINET-THEXCHANGE, INC.,

Defendant.

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ARBINET-THEXCHANGE, INC.,

DECISION and ORDER

Third Party Plaintiff,

- against -

ALEXANDER MASHINSKY,

Defendant.

-----X
KARLA MOSKOWITZ, J:

FILED
JAN 08 2007
NEW YORK
COUNTY CLERK'S OFFICE

In an action alleging violation of Article 8 of the Uniform Commercial Code (“UCC”), conversion and breach of contract, plaintiff, CHVP Founders Fund I, L.P., f/k/a CHVP Founders Exchange Fund, L.P. (“CHVP”), moves for summary judgment pursuant to CPLR 3212.

Background

CHVP is a Delaware limited partnership that was formed to acquire equity securities of emerging companies. On May 15, 2002, CHVP and counterclaim defendant, Alexander Mashinsky (“Mashinsky” or “the founder”), who is also the founder of defendant Arbinet-Theexchange, Inc. (“Arbinet”), entered into a contribution agreement in which Mashinsky exchanged 3,000,000 shares of his Arbinet common stock for a limited partnership interest in CHVP. (Plevin Aff. Para. 3 and Ex. A). Section 6.07 of that agreement states: “Securities

Ownership. [Mashinsky] is the sole record and beneficial owner of the Shares. Except as set forth on Schedule 6.07, [Mashinsky's] right title and interest in the Shares are free and clear of all Liens, Transfer restrictions, options, charges, voting trusts, voting agreements and restrictions of any nature whatsoever." Schedule 6.07 states that, "the transfer of shares is subject to the restrictions set forth in the Company's Third Amended and Restated Co-Sale and Right of First Refusal Agreement dated as of July 3, 2001." ("the Co-Sale Agreement") (Plevin Aff, pp. 12 & 29).

The Co-Sale agreement required Mashinsky to give Arbinet, and certain of its investors, the right of first refusal to purchase the 3,000,000 shares. Although Arbinet and its investors received notice of Mashinsky's proposed sale of the stock to CHVP, they did not exercise their first refusal right and, on February 27, 2002, Arbinet's Chief Executive Officer authorized Mashinsky to transfer the common stock to CHVP. Thereafter, on July 24, 2002, Arbinet issued a stock certificate naming CHVP as owner of the 3,000,000 shares.¹ The certificate indicates that it is subject to the sales restrictions of the Securities Act of 1933 but does not contain a legend alerting the holder that the shares are subject to any other sales restrictions.

It is undisputed, however, that, as an Arbinet shareholder on July 3, 2001, Mashinsky was also bound by The Third Amended and Restated Investors Rights Agreement, as amended, ("Third Agreement") that provided, in Section 1.13, for the following restriction on the sale of Arbinet's common stock:

¹ At a later date, Arbinet recapitalized and reduced the number of shares CHVP owned to 187,500.

“Market Stand-Off Agreement. Each Holder² agrees that, in connection with any underwritten public offering of [Arbinet’s] Common Stock, it shall not, if requested by [Arbinet] and the underwriters managing such underwritten offering of [Arbinet’s] Common Stock, sell . . . or otherwise transfer or dispose of . . . any Registrable Securities . . . without the prior written consent of the Company or such underwriters . . . for such period of time (not to exceed 90 days) from the effective date of Such registration

(Plevin Aff, Ex. C, p. 20).

Section 1.11 of the Third Agreement permitted a holder, other than the founder, to transfer or assign his registration rights in the stock he/she transfers to an affiliate, “provided, however, that, in each such case, such assignment shall be effective only if immediately following such transfer the transferee is bound by the terms and conditions of this agreement” (Plevin Aff, Ex. C., p.19 [emphasis in original]).

On May 10, 2003, Arbinet issued a Fourth Amended and Restated Investors’ Rights Agreement (“Fourth Agreement”) that superseded the Third Agreement in its entirety. (Plevin Aff., Ex. I, pp. 26-27). Section 1.13 of the Fourth Agreement substantially restates the 90 day Market Stand-Off restriction articulated in the Third Agreement, but makes the stand-off applicable to “combined holders,” defined as the holders and the founder, and that section further permits Arbinet to enforce the 90 day stand-off provision by imposing stop transfer instructions with respect to the securities of each combined holder. Section 1.11 of the Fourth Agreement

² Holder is defined in Section 1.01(e) of the Third Amended and Restated Investors’ Rights Agreement as “any person owning or having the right to acquire Registrable Securities or any permitted assignee thereof” CHVP takes the position that the founder did not own “registrable securities” as that term is defined in the document, and thus CHVP, as assignee/transferee of his shares, did not own “registrable securities” and was not a holder under the terms of the third agreement.

permits holders, other than the founder, to assign or transfer their registration rights in transferred securities to an affiliate provided that such transfers of the holder's registration rights "shall be effective only if immediately following such transfer the transferee executes a joinder agreement, which indicates that the assignee is bound by the terms and conditions of this Agreement" It is undisputed that CHVP did not sign and was not a party to the Fourth Agreement.

On December 16, 2004, Arbinet made a first public offering ("FPO") of its common stock and the shares began trading on the Nasdaq Exchange under the symbol ARBX. The prospectus that Arbinet published in connection with the FPO advised investors that, "shares of our common stock eligible for sale under Rule 144(k) may be sold immediately upon the completion of this offering" unless they are subject to a 180 day lock-up agreement with Merrill Lynch.

Under the heading Rule 144(k), the prospectus states, in pertinent part:

In general, under Rule 144(k), a person may sell shares of common stock acquired from us immediately upon completion of this offering, without regard to the manner of sale, the availability of public information or trading volume, if:

the person is not our affiliate and has not been our affiliate at any time during the three months preceding such a sale; and

the person has beneficially owned the shares proposed to be sold for at least two years, including the holding period of any prior owner other than an affiliate.

Accordingly, on the date of the FPO, Rule 144(k) was not a bar to CHVP's stock sale.

Under the heading Lock-Up Agreements, the prospectus states that "substantially all" of the outstanding stockholders have agreed not to sell or otherwise dispose of their shares of common stock for a period ending 180 days after the date of the prospectus. (Plevin Aff, Ex. I

pp. 95-96). It is undisputed that CHVP's shares were not subject to a 180 day lock-up agreement with Merrill Lynch

In order to sell its shares on the date of the initial public offering, CHVP requested Arbinet's customary opinion for removal of the Securities Act legend on the stock certificate. Arbinet refused to issue the opinion. Rather, Arbinet took the position that CHVP was subject to a 90 day lock-up on the sale of its shares despite CHVP's protests that it was not a party to the Third or Fourth Agreements and therefore not subject to the lock up provisions contained in those documents.

Because Arbinet refused to issue the opinion, CHVP did not commence selling its Arbinet common stock until March 17, 2005, the day that the lock-up expired. It completed the sale of its stock seven weeks later, on May 10, 2005, by which time the stock had declined in value.

CHVP commenced this action alleging that it incurred damages because of Arbinet's wrongful refusal to register the 187,500 shares of common stock. The complaint states causes of action for violation of Article 8 of the UCC, conversion and breach of contract. Arbinet has answered the complaint and commenced a third-party action against Mashinsky.

Plaintiff's Argument in Support of Summary Judgment

CHVP relies solely on the Co-Sale Agreement and/or the Third or Fourth Agreements to support its contention that the shares it purchased from Mashinsky were not subject to restrictions on the sale of its common stock and, thus, were eligible for sale on the date of the initial public offering.

Co-Sale Agreement

It is CHVP's position that the July 3, 2001 Co-Sale Agreement only imposed restrictions on Arbinet's existing shareholders as of that date; that Section 6 of the Co-Sale Agreement required Arbinet to put a restrictive legend on the shares covered by the agreement and that its stock certificate did not contain such legend; and that, pursuant to Section 8, the Co-Sale Agreement terminated on the date of the FPO.

Third Agreement

CHVP argues that the Third Agreement is of no force and effect because the Fourth Agreement superseded it in its entirety on May 30, 2003. Alternatively, CHVP argues that, even if the Third Agreement somehow survives, that agreement only applies to "holders" and CHVP is not a "holder" as that term is defined in the agreement. (*See, n2, supra*).

Fourth Agreement

CHVP states that it did not sign or otherwise become a party to the Fourth Agreement and, accordingly, the restrictions in the Fourth Agreement do not apply to it.

Damages

CHVP contends that, under Delaware law, in a case involving a temporary restriction on a shareholder's ability to sell its shares, damages are measured by calculating the difference between (1) the highest intermediate price of the shares during the beginning of the wrongfully restricted period; and (2) the average market price of the shares during a reasonable period after the restrictions were lifted.

Arbinet's Argument in Opposition to Summary Judgment

Arbinet contends that the summary judgment motion is premature because the parties

have not had an opportunity to conduct discovery and that facts and documents that Arbinet needs to oppose the motion are exclusively in CHVP's possession. Moreover, Arbinet argues that there are factual disputes about several key issues in this matter, to wit: (1) whether CHVP is the lawful owner of the shares; (2) whether CHVP conceded that its shares were subject to the market standoff restrictions; and (3) whether Mashinsky, through the Co-Sale Agreement, was obligated to bind CHVP to the Third Agreement. Arbinet also argues that plaintiff's damages claim involves complicated issues of stock valuation and requires discovery and expert testimony. In addition, for the first time at oral argument, Arbinet argued that there is a question of fact as to whether it had a reasonable basis for denying the transfer because, even though the stock did not bear a restrictive legend, CHVP had full knowledge of the Market Stand-Off restrictions in the Third Agreement.³

DISCUSSION

Summary Judgment

On a motion for summary judgment, the proponent of the motion must make a *prima facie* showing of entitlement to judgment as a matter of law by advancing sufficient "evidentiary proof in admissible form" to demonstrate the absence of any material issues of fact. (*Winegrad v New York Univ. Med. Ctr.*, 64 N.Y.2d 851, 853 [1985]; *Zuckerman v City of New York*, 49 N.Y.2d 557,562 [1980]). The motion must be supported by "affidavit [from a person having knowledge of the facts], by a copy of the pleadings and by other available proof, such as depositions." (CLR 3212[b]).

³ By letter dated December 19, 2006, Arbinet requested the court's permission to submit a sur-reply brief regarding the question of whether it acted reasonably under the circumstances. The court denied Arbinet's request and did not consider the sur-reply brief attached to the letter.

Alternatively, to defeat a motion for summary judgment, the opposing party must show facts sufficient to require trial of any issue of fact. (CLR 3212[b]). Thus, where the proponent of the motion makes a *prima facie* showing of entitlement to summary judgment, the burden shifts to the party opposing the motion to demonstrate, by admissible evidence, the existence of a factual issue requiring a trial of the action, or tender an acceptable excuse for the failure to do so. (*Vermette v Kenworth Truck Co.*, 68 N.Y.2d 714 (1986); *Zuckerman v City of New York*, *supra* at 560). Mere conclusions, expressions of hope or unsubstantiated allegations are insufficient. (*Alvord and Swift v Steward M. Muller Constr. Co.*, 46 N.Y.2d 276 [1978]; *Fried v Bower & Gardner*, 46 N.Y.2d 765 [1978]).

Applicable Law

New York has adopted section 8-106 of the Uniform Commercial Code, that requires, in actions regarding the rights and duties of a securities issuer with respect to registration of a certificated security, the court to apply the substantive and choice of law rules of the jurisdiction in which the issuer is incorporated. Because Arbinex is incorporated in Delaware, that has also adopted section 8-106 of the Uniform Commercial Code (Del. Code Ann. Tit. 6 Section 8-106), the court will analyze Arbinex's duties with respect to registration under Delaware Law. (*Catizone v Memry Corp.*, 897 F. Supp. 732 [SDNY 1995]; *DeWitt v American Stock Transfer Co.*, 433 F. Supp. 994, *modified on other grounds*, 440 F. Supp. 1084 [SDNY 1977]).

Section 8-401 of the Delaware Uniform Commercial Code

Section 8-401 of the Delaware Uniform Commercial Code (Del. Code Ann. Tit. 6, Section 8-401) states, in pertinent part:

(A) If a certificated security in registered form is presented to an

an issuer with a request to register transfer or an instruction is presented to an issuer with a request to register transfer of an uncertificated security, the issuer shall register transfer as requested if:

* * * *

(5) the transfer does not violate any restrictions on transfer imposed by the issuer in accordance with Section 8-204;

* * * *

(B) If an issuer is under a duty to register a transfer of a security, the issuer is liable to a person presenting a certificated security or an instruction for registration or to the person's principal for loss resulting from unreasonable delay in registration or failure or refusal to register the transfer.

Section 8-204 of the Delaware Uniform Commercial Code states that "[a] restriction on transfer of a security imposed by the issuer even though otherwise lawful is ineffective against any person without actual knowledge of it unless (a) the security is certified and the restriction is noted conspicuously thereon."

Accordingly, the court must determine whether CHVP has made a *prima facie* showing that, based on the clear and unambiguous language of the Co-Sale Agreement and the Third and Fourth Agreements, that Arbinet did not have a reasonable basis to deny the transfer and, thus, that CHVP is entitled to judgment as a matter of law.

It is the well-settled rule of contract law that:

The proper construction of any contract is purely a question of law. Clear and unambiguous language . . . should be given its ordinary and usual meaning. When the language . . . is clear and unequivocal, a party will be bound by its plain meaning because creating an ambiguity where none exists, could, in effect create a new contract with rights, liabilities and

duties that the parties had not assented to.

(Rhone-Poulenc Basic Chemicals Co. v American Motorists Ins. Co., 616 A.2d 1192 [Del. Supr. Ct. 1992] [internal citations omitted])

CHVP correctly argues that it was never a party to the Co-Sale Agreement, and, even if it had been a party, the restrictions that the Co-Sale Agreement imposed on the sale of common stock, if any, expired on the date of the FPO.⁴ Similarly, CHVP has established that any restrictions imposed on the sale of common stock in the Third Agreement are not relevant because it was not a party to that agreement, and, even if it had been a party on the date that CHVP attempted to sell its stock, the Third agreement had been superseded in its entirety by the Fourth Agreement.⁵ Finally, Arbinet does not dispute that CHVP did not sign and was not a party to the Fourth Agreement so that any Market Stand-Off restrictions in the Fourth Agreement do not apply to CHVP.

Accordingly, CHVP has established its *prima facie* case that Arbinet had not placed any restrictions on the sale of CHVP's stock and that Arbinet's refusal to register CHVP's stock was wrongful. The burden now shifts to Arbinet to demonstrate that there is a genuine issue of material fact requiring a trial of this action.

Arbinet's contention that its actions were reasonable because CHVP had actual

⁴ Section 8 of the Co-Sale Agreement states, in pertinent part, "This agreement shall terminate and be of no further force and effect upon the earlier of (a) an FPO"

⁵ Section 2.12 of the Fourth Agreement states, in pertinent part, "the parties hereto acknowledge and agree that the Prior Agreement has been superseded in its entirety by this agreement and that the prior agreement is of no further force or effect."

Moreover, the Fourth Agreement states on pages 1-2, "the parties to that certain Third . . . Agreement dated as of July 3, 2001 . . . desire that the agreement be amended and restated in its entirety in the form hereof."

knowledge of and therefore was bound by the Market Stand-Off provision in the Third Agreement is without merit. At the time CHVP attempted to register its stock, the Third Agreement had been superseded in its entirety by the Fourth Agreement and it is undisputed the CHVP was not a party to the Fourth Agreement. Therefore, based on the clear language of the agreements at issue, Arbinet did not have a reasonable basis to refuse to register the securities.

Because the court finds that the documents are dispositive of the issue of Arbinet's liability in this matter, it will not reach Arbinet's additional arguments in opposition to summary judgment.

Damages

Under Delaware law, in a case involving a temporary restriction on a shareholder's ability to sell its shares, damages are measured by the difference between (1) the Hypothetical Sales Price (the highest intermediate price of the shares at the beginning of the wrongfully restricted period) and (2) the average market price of the shares during a reasonable period after the defendant lifted the wrongful restrictions. (*Duncan v Theratx, Inc.*, 775 A.2d 1019 [Del. Supr. 2001]; *Madison Fund Inc. v Charter Co.*, 427 F.Supp. 597 (SDNY 1977).

In this case, CHVP began selling its 187,500 shares of common stock on the day the 90 day Market Stand-Off restrictions expired, and it completed selling all of its shares seven weeks later. CHVP contends that the seven weeks was the reasonable time period required to dispose of the shares without disturbing the market price (*Duncan v Theatrix, Inc.*, 775 A.2d at 1024 n. 14) and therefore that its damages should be calculated as the difference between the closing stock price on the first day of the FPO (\$29.00) and the average share price during the seven weeks it took to dispose of its shares after the restriction was lifted (\$19.90). According to

CHVP, the loss was \$9.90 per share multiplied by 187,500 shares for a total of \$1,856,250.

Arbinet correctly argues that there are questions of fact regarding whether seven weeks was a reasonable time period required for the sale of the stock without disturbing the market price and what impact, if any, a block sale of the shares would have had on the market price.

Accordingly, it is

ORDERED that, that branch of plaintiff's motion seeking summary judgment on liability is granted and the motion is otherwise denied. The damages claim is severed and continued and the parties are directed to appear in Part 3, 60 Centre St., Room 248 on the 13th day of February, 2007 at 10:30 a.m. for a preliminary conference on the issue of damages.

This decision constitutes the order of the court.

Dated: January __, 2007



J.S.C.

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