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Delaware Court Finds Two Transactions Not Entirely Fair

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Editor's Note: The following post comes to us from David J. Berger, partner focusing on corporate governance at Wilson Sonsini Goodrich & Rosati, and is based on a WSGR Alert memorandum. This post is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

On September 4, 2014, the Delaware Court of Chancery issued two lengthy post-trial opinions,[1] both authored by Vice Chancellor John W. Noble, finding that recapitalization or restructuring transactions did not satisfy the entire fairness standard of review. Although plaintiffs in each instance had received a fair price, the court found that the defendants had employed unfair processes and breached their fiduciary duties.

Significantly, one of the cases involved a recognizable set of facts: various plaintiff stockholders challenged a recapitalization that was approved at the same time the company conducted an "insider" round of financing as the company was running out of cash. The recapitalization and financing were approved by a five-member board of directors, three of whom were designated by venture capital funds that either participated in the financing or were said to have received a special benefit, with no participation by the company's other stockholders. While the company received an informal and insider-led valuation of $4 million at the time of the recapitalization, the court found that the company's equity at that time actually had a value of zero. However, as a result of the recapitalization, the company was able to acquire new lines of businesses. Four years after the recapitalization, the company was sold for $175 million. Following the sale, six years of litigation unfolded.

As summarized below, despite concluding that the transactions at issue in the two cases were not entirely fair and were the result of a breach of fiduciary duties, the court declined to award damages in light of its conclusion in each instance that the price was fair or the damages sought

[1] *In re Nine Systems Corp. Shareholders Litigation*, C.A. No. 3940-VCN (Del. Ch. Sept. 4, 2014) ("*Nine Systems*") and *Ross Holding and Management Co. et al., v. Advance Realty Group LLC, et al.,* C.A. No. 4113-VCN (Del. Ch. Sept. 4, 2014) ("*Ross Holding*").

by plaintiffs were too speculative.[2] In addition, in both cases the court gave the plaintiffs leave to seek attorneys' fees and costs. Together, these two decisions illustrate the emphasis that Delaware courts place on "process" and raise important questions for companies facing financial extremis in similar circumstances.

In re Nine Systems Corp. Shareholders Litigation

In *Nine Systems*, the board of a small venture-backed technology company approved a 2002 recapitalization transaction that significantly diluted the non-participating minority holders. The stockholder approval necessary for the transactions was generally obtained from the investors "around the table." At the time, the five-member board included the CEO and three designees of a group of investors who owned 54 percent of the company's stock combined and held more than 90 percent of the company senior debt.

At the time of the recapitalization, the company was valued at $4 million. The directors serving on the board were not receiving compensation for their services, and the company could not afford to purchase directors and officers liability insurance. As part of the recapitalization, two of the three defendant investors agreed to invest additional funds so that the company could remain a going concern and pursue its business plan. The third investor, whose designee also approved the recapitalization, received an informal 90-day option to participate in the financing and the benefits of the recapitalization (an option that was not given to the minority stockholders).

As a result of the recapitalization, which allowed the company to purchase new lines of business, the company began a turnaround effort. This effort was not without problems; indeed, two years after the recapitalization, the company's CEO asked senior management to defer their paychecks for the company so that it could meet payroll. The company did eventually become successful, and four years after the recapitalization, the board was able to sell the company for $175 million. Following the sale, certain minority stockholders challenged the recapitalization. The litigation would last for six years, and ultimately, a trial was held over 11 days that involved approximately 1,000 exhibits.

In its post-trial opinion, the court applied the entire fairness standard—the standard applicable when either a majority of the board has a conflict in a transaction or when a controlling stockholder or a control group of stockholders receives a special benefit as compared to stockholders generally (with the court finding each circumstance to be the case here), and which requires a court to examine the fairness of the process and terms associated with the transaction.

[2] Even in the absence of an award of damages for which directors are personally liable, a finding that a director has breached his or her fiduciary duties may have important consequences with respect to, for example, the director's right to indemnification.

The court acknowledged that the “general initiation” of the recapitalization was fair given that the company was running out of money and its business plan had proven unsuccessful, but that the “specific sequence of events” undertaken to implement the recapitalization was not fair. The court went on to find several aspects of the process unfair.

The court was critical of the board for knowingly excluding the one independent director, who often vocally opposed the potential transactions, from meetings and for not providing him with board materials on the same timeline as the other directors. The court also rejected the defendants’ argument that the independent director’s ultimate support of the transaction was evidence of its fairness where there was “no effort to condition the [r]ecapitalization on his approval or that of disinterested stockholders” and instead an effort to cut him out of the deliberations. The court found that the lone independent director “had no effective bargaining power to challenge” the conflicted directors because the transaction was not conditioned upon his approval. Indeed, in rejecting the argument that the minority’s interests had been adequately protected because the independent director had advocated on their behalf, the court explained that the conflicted directors’ argument was “premised on a seriously flawed misunderstanding of the nature of fiduciary duties under Delaware law” and that “[d]irectors owe fiduciary duties to all stockholders, not just a particular subset of stockholders [and the lone independent director] was not the only director who owed fiduciary duties to the minority.”

The court also found that the directors did not adequately understand how the $4 million valuation that the board used in the recapitalization came about. The court found that this valuation was essentially done by a principal of one of the interested investors on a “back of the envelope” basis. It pointed to the fact that the board failed to engage an independent financial advisor and, therefore, “needed to be adequately informed about what substantiated the $4 million valuation” but was not.[3]

Finally, the court faulted the board’s disclosures, which were provided in part in the notice that the company was required to send under Section 228 of the Delaware General Corporation Law following an action by written consent of stockholders (as had occurred in this case in amending the company’s charter) to the non-consenting stockholders, for failing to disclose critical information about who participated in the recapitalization and the precise terms of the recapitalization. Thus, the court concluded that the disclosures were materially misleading and were “powerful evidence of unfair dealing.”

[3] The court acknowledged that Delaware law does not require a board to obtain an independent financial advisor; it instead indicated that hiring such an advisor would have been one way for the defendants to show they had been reasonably informed. The court recognized that there may be times when the cost or timing of obtaining financial advisor input might be prohibitive, but found such an argument “undermined” in this case, in part because the company “hire[d] three agencies to work for ‘months’ on a possible name change.”

Having found that the board's approval of the restructuring was procedurally unfair, the court turned to the question of "fair price." The court extensively analyzed the expert testimony provided by both sides in the case and ultimately found the testimony of the defendants' expert to be more credible. Specifically, the court concluded that the equity value of the company before the recapitalization was $0—substantially lower than the $4 million valuation used for purposes of the recapitalization. As a result, it found that while the process was improper, the valuation was, in fact, fair.

Thus, the court was required to determine whether a transaction characterized by a fair price and an unfair process was "entirely fair." It concluded that if the "unitary" nature of the entire fairness standard is to have any meaning then a "grossly unfair process" can render an otherwise fair price not entirely fair. In doing so, the court expressly distinguished the Court of Chancery's decision in *In re Trados Shareholder Litigation*, in which the court, after characterizing the defendants' process as unfair, concluded that the defendant directors "nevertheless proved that the transaction was fair" because the common stock had no value at the time of the merger. Here, the court stated that it "does not interpret Trados for the broad proposition that a finding of fair price, where a company's common stock had no value, forecloses a conclusion that the transaction was not entirely fair. Rather, the Trados conclusion reinforces the defining principle of entire fairness—that a court's conclusion is *contextual*" (emphasis in original).

The court went on to find that the director defendants had failed to meet their burden to establish the transaction's entire fairness, and that they had therefore breached their fiduciary duties. It also found that other defendants (the funds and a principal of one of the funds), to the extent they did not directly owe fiduciary duties to the minority as members of a control group, had aided and abetted the directors' breaches.

However, despite finding that the director designees breached their fiduciary duties, the court found "that it would be inappropriate to award disgorgement, rescissionary, or other monetary damages to the plaintiffs" because, although the court had concluded that recapitalization was not fair to the plaintiffs, it was "nonetheless effected at a fair price." The court reached this conclusion while also noting that "the Defendants received approximately $150 million of the $175 million in consideration," with those defendants investing in the last round of preferred stock financing receiving "almost a 2,000% return," a portion of which otherwise may have gone to the minority holders but for the dilution.

At the same time, the court recognized that "but for" the recapitalization, it was not clear that the company would have been worth any amount approaching the damages sought by plaintiffs. The court nonetheless invited the plaintiffs to petition the court for an award of attorneys' fees as a remedy for the defendants' breaches.

Ross Holding and Management Co. v. Advance Realty Group

The second decision, *Ross Holding*, addressed somewhat similar questions in the context of a Delaware limited liability company whose operating agreement allowed for the application of traditional fiduciary duties. There, the board of managers of a real estate development and investment LLC conducted a reorganization that was intended to spin off the LLC's capital-intensive, undeveloped properties to minority unitholders, leaving the LLC's most profitable assets to its largest institutional investor for the LLC's CEO to manage. The plaintiffs, minority unitholders who, as part of the reorganization, chose to retain their interests in the existing LLC rather than be cashed out or accept interests in the spun-off entity, challenged the reorganization. Because all four members of the board were either interested in the transaction or beholden to interested entities, the court reviewed the transaction for its entire fairness and placed the burden of proof on the defendants.

As in *Nine Systems*, the court ultimately found that the transaction was not entirely fair to the plaintiffs because the process employed was not fair to the LLC's minority unitholders. Specifically, with respect to process, the court noted that the directors had acknowledged acting primarily out of self interest (or the interests of their sponsors) throughout the reorganization process and found that the minority unitholders' interests had been merely "an afterthought." The court criticized the board for capitulating to the institutional investor's desire to monetize its investment and for granting that investor the right, not shared by other unitholders, to convert its equity to debt. The court also was concerned that the board had executed the reorganization without notice to the minority and generally kept the minority uninformed about the transaction. It also observed that, apparently due to cost and time pressures, the board had not obtained a fairness opinion in connection with the transaction.

Focusing on fair price, the court observed that the *Ross* plaintiffs, unlike other minority investors who accepted lesser consideration, had, like the institutional investor, retained their interests in the pre-reorganization LLC. Relying primarily on work of the defendants' financial expert (and noting that the plaintiffs, too, had largely accepted that work), the court found that the post-reorganization value of the plaintiffs' units seemed to be "within a range of reasonable values" and had, in fact, increased through the reorganization. Thus, it concluded that the plaintiffs had received a fair price.

Considering the process employed by the board together with the price received by the plaintiffs, the court concluded that the reorganization was not entirely fair and that the defendants had breached their fiduciary duties. Still, because the plaintiffs were "among the beneficiaries of the Reorganization," the court held, as it did in *Nine Systems*, that damages were not available to plaintiffs here.[4]

Takeaways:

- In both decisions, the court was clearly swayed by what it viewed as grossly unfair processes employed by interested directors. The decision in *Nine Systems* makes clear that the determination of entire fairness is "contextual," and discovery and trial in these types of cases can be extensive. Indeed, the decisions in *Nine Systems* and *Ross Holding*, topping out at 146 and 100 pages respectively, contain lengthy fact patterns following years of discovery and lengthy trials, which allowed the court to identify the procedural infirmities that led to its conclusion in each instance to find that the transactions were unfair.
- Both decisions recognize the importance of independent directors in employing procedural safeguards under Delaware law. In that respect, *Nine Systems*, in particular, highlights a significant potential dilemma faced by venture-backed start-ups (or other corporations facing financial extremis). It is hard to imagine, for example, that a company such as Nine Systems would be able to attract additional independent directors when it could not pay directors for their service on the board, afford D&O coverage for them, or retain any expert independent advisers to assist them in their duties as directors. Directors of companies facing similar challenges will need to think creatively to satisfy the process requirements of Delaware law, paying particular attention to their duties to *all* the company's stockholders, including the minority and/or common stockholders.
- *Nine Systems* also further demonstrates the potential for "hindsight litigation risks" in that, as the court observed, "but for" the challenged 2002 recapitalization, the company would not have been worth anywhere near the value ascribed to it in the 2006 sale and may likely have failed. Had the company failed, it is likely that there would have been no litigation; instead, the company's success resulted in years of litigation. *Nine Systems* thus demonstrates the importance of attempting to establish, even in the most difficult of circumstances (i.e., when a company is on the verge of failing), a process that is fair to *all* stockholders at the outset of a transaction since directors need to understand that if the company is able to ultimately succeed, there is a risk that the board's earliest decisions

[4] Nonetheless, the court found that the board had acted unreasonably by granting certain notes to institutional defendants through the reorganization, and it invited the plaintiffs to submit additional briefing on the questions of whether granting those notes had harmed the plaintiffs and whether the notes should therefore be unwound. As it did in *Nine Systems*, the court also invited briefing on the topic of attorneys' fees in *Ross Holding*.

will be examined in hindsight after many years of litigation and in an extensive and very public trial.

- *Nine Systems* also underscores the potential risks for venture capital funds and principals in fact patterns like the one at hand, as the court found that the venture capital funds (and one of the principals of the funds who was heavily involved in the company's affairs) either comprised a control group with fiduciary duties or could be liable for aiding and abetting the directors breaches of their duties.
- Both opinions highlight the substantive importance of offering credible expert testimony in the context of demonstrating fair price under an entire fairness analysis (or fair value in the context of an appraisal proceeding). In *Nine Systems*, the court essentially adopted the testimony of the defendants' financial expert wholesale. In *Ross Holding*, the failure of plaintiffs to offer credible financial expert testimony, and their reliance on defendants' expert, contributed to the court's acceptance of the defendants' theory on damages.