On the Trail of Fairness: The Lessons of Bloodhound

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Introduction

Inspired by dreams of eventually selling their companies for huge pay-days, entrepreneurs typically start their new ventures with majority ownership of the business enterprise and broad decision-making authority. However, for companies that grow by taking on venture capital investment, these dreams can fade from memory as successive rounds of financing cause this initial level of founder control to dwindle over time. The facts of the recently decided Delaware court case of *Carsanaro, et al. v. Bloodhound Technologies, Inc., et al.* reflect an extreme example of this shift in control. The court's preliminary decisions in the case serve as a cautionary tale to both venture capital investors and directors of venture-backed companies of the pitfalls that lurk in connection with dilutive financing rounds and the sales of businesses.

Facts of the Case

Joseph Carsanaro founded Bloodhound Technologies, Inc. ("Bloodhound" or the "Company") in 1998 with a view towards creating web-based software applications that would allow healthcare providers to monitor for fraud. Over the course of the next four years, the Company issued five series of preferred stock to investors, designated Series A through Series E, raising approximately $15 million of investment capital in the process; the price per share of preferred stock paid by investors fluctuated up and down throughout these financings until the Company's valuation fell precipitously from its Series D to Series E financing rounds. During this time, Mr. Carsanaro and four other members of his founding team were eased out as employees of the Company and he and one of his fellow founders both resigned from the Company's Board of Directors at the behest of the Company's venture capital investors. These investors went on to expand the size of the Board of Directors such that a majority of the Board was comprised of designees of these investors.

Over the next several years, the Company proceeded to issue additional shares of its Series E Preferred Stock to existing investors and other related parties at the same low valuation as the initial Series E financing despite the fact that the Company's financial performance was steadily improving. Ultimately, the Board approved a sale of the Company to Verisk Health Inc. for $82.5 million in April 2011 (the "Merger"). Contemporaneous with its approval of the Merger, the Board also authorized the establishment of a management incentive plan (the "MIP") that granted senior managers of the Company awards totaling $15 million, equal to nearly 19% of the total consideration in the Merger. At the time of the sale of the Company, the aggregate ownership of all common stockholders of the Company had been diluted to 2.18% on an as-converted basis. Mr. Carsanaro and his fellow founding team members, the plaintiffs in the *Bloodhound* case, owned less than 1% of the total equity of the Company at the closing of the

Merger and, by virtue of the liquidation preferences of the preferred stockholders and the MIP awards, they received less than $36,000 in connection with the sale of the Company.

The Claims

The plaintiffs brought suit against the Bloodhound Board of Directors and the directors' affiliated investment funds in the Delaware Court of Chancery, alleging breaches of fiduciary duties and statutory violations under Delaware law related to the Company's dilutive preferred stock financings and the allocation of transaction proceeds under the MIP. The defendants moved to dismiss these claims on a wide range of theories and, with limited exceptions, the court denied defendants' motions, holding that the plaintiffs stated actionable claims on many of their theories of relief.

Breach of Fiduciary Duty – Series D and Series E Preferred Stock Financings

The plaintiffs claimed that the Company's Board of Directors at the time of the Company's Series D Preferred Stock financing (the "Series D Board") and its Series E Preferred Stock financings (the "Series E Board" and, together with the Series D Board, the "Boards") breached their fiduciary duties in approving those financings (respectively, the "Series D Financing" and the "Series E Financing" and, together, the "Financings"). Unlike earlier financing rounds, when the Company had approached several previously unaffiliated investors in an effort to obtain competitive financing terms, the Boards set the terms of the Financings unilaterally and authorized the issuance of virtually all of the shares issued in the Financings to the Company's existing investors and their principals. Concurrent with its approval of the Financings, the Boards also approved the issuance of shares of common stock to senior management, including certain individuals serving as directors on the Boards.

The defendants sought to dismiss the plaintiffs' claims of breach of fiduciary duty by relying on the "business judgment rule", the long-established default standard of review of board decisions under Delaware law[1]. In general, Delaware law is deferential to the decisions of corporate directors and provides directors with wide latitude in their stewardship of the corporation. However, the court rejected this standard of review in the *Bloodhound* case, focusing on the fact that each of the Boards were comprised of a majority of interested directors by virtue of some of the directors' affiliation with the Company's venture capital investors (who were issued shares in connection with the Financings) and due to the fact that some of the directors (who also served as members of the Company's senior management) were issued shares of common stock concurrently with the Financings. This meant that at the time of each of the Financings, there were not an adequate number of independent and disinterested individuals on the Boards to comprise a board majority and, as a result, the application of the business judgment rule to the Boards' actions was improper[2]. Instead, in light of the personal benefits conferred upon certain of the directors in connection with the Financings and the Company's failure to solicit interest in the Financings from new, unaffiliated investors, the court found that the plaintiffs had raised a reasonable inference that the terms of the Financings were unfair, shifting the burden to the defendants to prove that the Financings were products of both fair dealing and fair pricing.[3]

Breach of Fiduciary Duty – The Merger and the MIP

The plaintiffs also claimed that the Company's Board of Directors at the time of the Merger (the "Merger Board") breached its fiduciary duty in approving the Merger and the MIP. The Merger Board consisted of four directors, two of whom received MIP awards equal to nearly $8 million in the aggregate. Consequently, the court determined that the Merger Board did not include a sufficient number of independent and disinterested directors to comprise a board majority and, as a result, the application of the business judgment rule was improper and the defendants would bear the burden of proving that the establishment of the MIP was entirely fair. The court also found that the diversion of nearly 19% of the total consideration in the Merger through the establishment of the MIP supported a reasonable inference that the terms of the Merger were unfair.

Ineffective Stockholder Approval – Initial Series E Preferred Stock Financing

Finally, the plaintiffs claimed that the approval of the initial Series E Financing violated certain provisions of the Delaware General Corporation Law (the "DGCL").

In connection with the initial Series E Financing, the Series E Board approved a 10-1 reverse split of its outstanding common stock (the "Reverse Split") due to the decrease in the Company's valuation from the Series D Financing to the initial Series E Financing, a classic "cram-down" of investors not participating in a down-round financing. Procedurally, approval of the Series E Financing first required the filing of an amendment to the Company's existing certificate of incorporation (the "Charter Amendment") to effectuate the Reverse Split followed by the filing of a new amended and restated certificate of incorporation (the "Series E Charter") authorizing the shares of Series E Preferred Stock. Due to the adverse impact of the Reverse Split on the Company's common stockholders, the Charter Amendment required the approval of a majority of the common stockholders as a separate class.

As part of its approval of the initial Series E Financing, the Series E Board passed a resolution stating that the conversion prices of all of the Company's existing series of preferred stock would be proportionately adjusted as a result of the Reverse Split. In reality, however, the filed Series E Charter did not adjust the conversion prices of any of the Company's existing series of preferred Stock; as a result, the full impact of the Reverse Split fell on the shoulders of the Company's common stockholders. Accordingly, the court found that the initial Series E Financing violated Section 242 of the DGCL which states that a corporation may only amend its charter through a two-step process in which the Board of Directors first approves the amendment and then recommends it to the stockholders for subsequent approval. Importantly, this process requires that the amendment that is approved by the Board of Directors be the exact same amendment that is approved by the stockholders. This process was not followed in the Bloodhound case since the filed Series E Charter did not conform to the resolution passed by the Series E Board.

In addition, the court found that the Series E Financing violated Section 228 of the DGCL which dispenses with the need to call a stockholder meeting in order to approve corporate action(s) and instead permits stockholder approval to occur via written consent, provided that the consent sets forth the action(s) being taken. In the case of the Series E Financing, the written consent that was circulated to the common stockholders for approval referenced both the Charter Amendment and the Series E Charter as exhibits to the consent and incorporated their terms by reference but neither document was actually attached to the written consent prior to it being executed by the common stockholders. Accordingly, the court found that the Reverse Split had not been approved by a majority of the Company's common stockholders as required by Delaware law.

Conclusions

It is important to note that final decisions in the *Bloodhound* case have not yet been delivered by the Delaware Court of Chancery; while the court denied most of the defendants' motions to dismiss the plaintiffs' claims for relief, this could ultimately prove to be a pyrrhic victory for the plaintiffs if the defendants go on to successfully prove the fairness of the Financings. Putting the preliminary nature of its decisions in context, the court acknowledged that venture capital investors often achieve control of their portfolio companies at both the board and stockholder levels and that many of the actions described in the plaintiffs' complaint could be consistent with efforts by properly motivated investors seeking to increase the value of a business. Nonetheless, theBloodhound case serves as a stark reminder of certain important procedural matters that should be followed by Delaware companies undergoing venture capital financings or corporate sales and questions the validity of some standard practices of venture capital investors, namely:

1. Process is important. When soliciting stockholder approval of corporate action(s), a board of directors should always take care to submit the exact actions that have been approved by the board and not a variation of what was approved. In addition, if the corporate action(s) are to be

approved via written consent and not at a meeting of stockholders, it is important to attach any documents that are referenced in the consent as exhibits prior to execution of the consent. By allowing the taking of immediate action without prior notice to minority stockholders, Section 228 of the DGCL creates the potential for mischief and courts require strict compliance with the language of the statute; failure to do so may result in a court determination that the stockholders did not make a legally-binding decision in approving the action(s) submitted to a vote.[4]

2. Director "interest" in a transaction will be narrowly construed. In a transaction where a benefit is being conferred upon a corporation's investors, directors that have been appointed by those investors will be viewed as having an "interest" in that transaction. In situations where a director is also a fiduciary of his/her affiliated investment fund, the existence of fiduciary responsibilities to multiple parties (i.e. the company and one of its investors) does not serve to dilute the director's fiduciary responsibilities to the corporation. Even more clearly, directors who receive direct benefits in connection with a transaction (such as the directors in the *Bloodhound* case that were sold shares of common stock in connection with the Financings) will also be characterized as having an "interest" in the transaction.

3. Boards of Directors that are not comprised of a majority of independent, disinterested directors may not rely on the default business judgment rule. The directors of a Delaware corporation typically have wide-ranging discretion in making decisions on behalf of the corporation and its stockholders; the business judgment rule presumes that, in making decisions on behalf of a corporation, directors act in good faith on an informed basis and in the belief that their actions are taken in the best interests of the corporation. However, reliance on the business judgment presupposes that the board of directors is comprised of a majority of independent, disinterested directors; as seen in the *Bloodhound* case, transactions approved by a majority-interested board will be closely scrutinized by a court and the board will bear the burden of proving that the transactions were entirely fair to the corporation and its stockholders. The common practice of venture capital investors appointing directors of their portfolio companies can make it difficult to achieve this level of board independence, especially in cases where a corporation has gone through successive rounds of financing with multiple investors. In light of this, investors should consider the composition of their portfolio company boards closely and involve outside, independent voices where possible. In situations where a majority of the board is interested in a particular transaction, the board should consider establishing a committee of independent, disinterested directors to separately approve the transaction.

4. Former stockholders may bring direct causes of action against the board of directors. While not the focus of this article, it bears mentioning that the *Bloodhound* may have also expanded stockholder rights significantly by allowing former stockholders of a corporation that has gone through a "cash-out" merger to bring direct (rather than derivative) claims against the corporation and its directors, especially in situations where corporate insiders have participated in the dilution of other stockholders' equity in the corporation.

For further information on this topic, please contact **Scott R. Bleier**.

Footnotes.

1. As framed by the Delaware Supreme Court in *Aronson v. Lewis*, the business judgment rule presumes that "…in making a business decision the directors of the corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." 473 A.2d 805, 812 (Del. 1984).

2. "…(If) the transaction is not approved by a majority consisting of the disinterested directors, then the business judgment rule has no application whatsoever." See *Aronson*, 473 A.2d at 812.

3. “Where actual self-interest is present and affects a majority of the directors approving a transaction, a court will apply…exacting scrutiny to determine whether the transaction is entirely fair to the stockholders. ”*Paramount Communications v. QVC Network Inc.*, 637 A.2d 34, 42 n.9 (Del. 1994).

4. *Empire of Carolina, Inc. v. Deltona Corp.*, 501 A.2d 1252, 1255-56 (De;. Ch. 1985), aff’d. 505 A.2d 452 (Del. 1985).