From *Trados* to *Nine Systems*: And Now for Something Completely Different?

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November 01, 2014

Introduction

The default business judgment standard of review under Delaware law creates a strong presumption in favor of the actions of the directors of a corporation and provides broad latitude to boards of directors in their oversight of a corporation's business. Under this deferential standard, a court will not review the decisions of directors who performed their duties in good faith, with care and in a manner that they reasonably believed to be in the best interests of the corporation. However, in situations where a majority of a board of directors is self-interested in approving a transaction on behalf of a corporation, a court will instead closely scrutinize the directors' behavior and require the directors to affirmatively prove that the approved transaction is entirely fair to the corporation and its stockholders. Delaware law has long held that satisfying the entire fairness standard of review is a two-pronged effort requiring directors to establish that the approved transaction was fair as to both price and process.[1]

The contours of entire fairness jurisprudence were left uncertain in the wake of the August 2013 post-trial decision in *Trados Inc.*[2] Shareholders Litigation (73 A.3d 17 (Del. Ch. 2013)), a case in which the court found a $60 million sale of a company was entirely fair to its stockholders despite the fact that common stockholders received no financial consideration in connection with the deal and notwithstanding the court's determination that the board of directors had employed a fundamentally flawed process in approving the transaction. In light of *Trados*, was the entire fairness standard truly a dual component test? Did process really matter at the end of the day?

The primacy of the two-pronged entire fairness test appears to have been reaffirmed by the court's recent decision in *Nine Systems Corporation* Shareholders Litigation[3] (2014 WL 4383127 (Del. Ch. Sept 4, 2014)), a case with facts resembling *Trados* in many respects but resulting in the opposite outcome: a transaction that was fair as to price was deemed not entirely fair to a corporation's stockholders due to a flawed approval process and breached fiduciary duties. With the ink on the *Nine Systems* decision barely dry, many observers may be left scratching their heads as to the current state of Delaware law in the area of director fiduciary duties. This article explores the factual background and legal analysis of each of these cases, identifying important distinctions and highlighting relevant lessons for boards of directors and legal practitioners alike.

Revisiting *Trados*

Before addressing *Nine Systems*, a revisit of the facts and analysis of *Trados* and the Court of Chancery's 2013 post-trial decision in that case is instructive.

Trados, Inc. was a venture-backed software company that had issued seven different series of preferred stock to investors, some of which were "participating preferred" and all of which carried 8% cumulative dividends. As a result of multiple rounds of equity financing, a majority of the company's board of directors came to be comprised of designees of its venture capital investors. Dissatisfied with the company's stagnant growth in the years following the bursting of the dot-com bubble, the *Trados* board of directors hired a new CEO and established a management incentive plan (the "MIP") that reserved a portion of the proceeds from an eventual sale of the company for designated senior managers. The company's performance eventually improved and its board of directors ultimately approved a sale of the company in June 2005 for $60 million. At the time of the sale, the total liquidation preference on the company's preferred stock was $57.9 million, including accumulated dividends. After paying 13% of the total deal consideration to management under the MIP and addressing various indemnification claims post-closing, the company's preferred stockholders ultimately received aggregate proceeds of $49.2 million, well below their total liquidation preference. Consequently, the company's common stockholders received nothing for their shares in connection with the sale of the company.

Subsequent to the sale of *Trados*, a common stockholder filed a lawsuit alleging breach of fiduciary duty by the company's board of directors. The court denied the defendant directors' motion to dismiss the lawsuit, finding that six out of seven directors were interested in the sale of the company and not independent (either by virtue of their outside relationships with the company's venture capital investors or due to being beneficiaries under the MIP). In addition, the court criticized the board's failure to adopt any protective provisions in the course of approving the sale of the company, noting that the approval of the company's disinterested and independent directors was not obtained and the closing of the transaction was also not conditioned on obtaining the separate vote of a majority of the company's disinterested common stockholders. As a result, the court determined that an entire fairness standard of review would apply to the transaction.

Despite misgivings about how the *Trados* board had initiated and negotiated the sale of the company and the manner by which director and stockholder approval of the transaction had been obtained, the court in *Trados* subsequently concluded in a post-trial decision that the company's directors had not breached their fiduciary duties in approving the sale of the company because the company's common stockholders received the economic value of their shares in connection with the transaction. The court found expert witness testimony regarding the value of the company at the time of the sale transaction credible and determined that the company did not have a realistic chance of generating sufficient return to escape the gravitational pull of the large liquidation preference and cumulative dividends held by the company's preferred stockholders. In the court's view, the doubtful long term viability of the company effectively overshadowed the imperfect process followed by the *Trados* board; as such, the consideration paid to the *Trados* common stockholders for their shares of stock – nothing – was fair.

The Facts of *Nine Systems*

Like *Trados*, *Nine Systems Corporation* (the "Company") was a venture-backed company, founded amidst the dot-com boom of the late 1990s as a streaming media start-up. Despite the lofty ambitions of the Company's founders, by early 2001 the Company was in dire need of cash to support ongoing operations and it turned to its existing investors for an infusion of capital. By the end of the year, as a result of equity and debt financings with these investors, the three defendant stockholders in *Nine Systems* together owned approximately 54% of the Company's stock and over 90% of its senior debt with the plaintiff stockholders together owning approximately 26% of the Company. Each defendant stockholder also had a designee on the Company's Board of Directors (the "Board").

In 2002, the Company continued to suffer from financial strain and sought to boost revenues and market share by making two strategic acquisitions of small companies (the "Targets"). The Company again turned to its stockholders to raise the capital needed for these transactions. Ultimately, the Board approved a recapitalization of the Company which involved the conversion of certain secured debt into a new class of preferred stock and the issuance of another class of preferred stock in exchange for an infusion of investment capital to finance the proposed acquisitions (the "Recapitalization"). Notably, the Board did not obtain an independent valuation of either the Company or the Targets in connection with the Recapitalization; rather, it accepted at face value a "back of the envelope" valuation provided by a large stockholder of one of the defendant stockholders participating in the Recapitalization. As a result of the Recapitalization, the three defendant stockholders' fully-diluted ownership of the Company increased to approximately 80%; in contrast, the plaintiff stockholders' fully-diluted ownership was reduced to approximately 2%.

In 2006, after several years of continued financial struggle, the Company fortunes took a dramatic turn for the better and, in December of that year, the Company was sold to *Akamai Technologies, Inc.* for $175 million. Approximately $150 million of the deal consideration was paid to the three defendant stockholders with the plaintiff stockholders altogether receiving approximately $3 million in connection with the transaction. Post-closing, when several of the Company's smaller stockholders learned details about potential conflicts of interest in the Recapitalization (presumably through proxy materials related to the *Akamai* transaction), the plaintiff stockholders filed suit with the Delaware Court of Chancery challenging the fairness of the Recapitalization and alleging breaches of fiduciary duty by the defendant stockholders' Board designees.

The Court's Analysis in *Nine Systems*

In reviewing the plaintiff stockholders' claims in *Nine Systems*, the Court of Chancery found that a majority of the Board was conflicted in approving the insider-led Recapitalization, focusing on the "dual fiduciary" status of the designees of the Company's venture capital investors serving on the Board. The court took pains to point out that it is not per se improper for a director of a Delaware corporation to also be a fiduciary for another party; on the contrary, such a situation arises regularly with start-up companies financed by venture capital investors. Nonetheless, the court stressed that a director who approves a stock issuance not offered to all stockholders of the corporation ceases to be independent if he/she is in a fiduciary relationship with a recipient of the newly-issued stock and faces an inherent conflict of interest as a result. Given the absence of a disinterested and independent majority of the Board, the court ruled that the entire fairness standard of review would apply to the Recapitalization.

Having determined that the defendant directors would bear the burden of proving that the terms of the Recapitalization were entirely fair to the Company and its stockholders, the court next focused on the two components of the entire fairness standard of review: fair dealing and fair price.

In terms of procedural fairness, the court labelled the process employed by the Board, as "grossly inadequate" and "beyond unfair." The court based this characterization on several damning facts, most notably (i) the Board's failure to be adequately informed about the valuations of the Company and the Targets (including a failure to request and review the valuation methodologies used by the representative of the defendant stockholder that had calculated the valuations), (ii) the Board's marginalizing of an independent director who initially objected to the Recapitalization (including the exclusion of that director from at least one Board meeting and other informal discussions between the defendant directors and not providing that director with important materials on the same timeline as the defendant directors), and (iii) the Board's concealment of the material terms of the Recapitalization from the company's other stockholders (both by failing to promptly notify the other stockholders of the charter amendment filed in connection with the Recapitalization and by failing to identify which stockholders participated in the Recapitalization and the terms of their participation).

The court found the defendant directors' arguments as to fairness of price more persuasive. In an analysis that effectively became a battle of the experts, the court determined that the fair value of the Company's stock at the time of the Recapitalization was within a range from -$4.33 million to -$1.75 million. Because the equity of the plaintiff stockholders had no value at the time of the Recapitalization, the dilution suffered by the plaintiffs as a result thereof could not be deemed unfair since "the plaintiffs necessarily received the substantial equivalent in value of what they had before."

Thus, as in *Trados*, the court in *Nine Systems* found that the transaction challenged by the plaintiff stockholders was the product of a faulty process involving a conflicted board of directors but was nonetheless fair as to price. However, in striking contrast to the decision in *Trados*, the court in *Nine Systems* went on to rule that the Recapitalization was not entirely fair to the Company's stockholders despite the defendant directors' having established fairness of price. In making this determination, the court insisted that *Trados* does not stand for the broad proposition that a finding of fair price forecloses a conclusion that a transaction was not entirely fair. Rather, the court stressed that a court's conclusion as to entire fairness is contextual in nature. And, in *Nine Systems*, the process employed by the Board was found to be so grossly unfair that it rendered an otherwise fair price not entirely fair.

Conclusions

After *Trados*, stockholders of venture-backed companies were left openly wondering whether the entire fairness standard review of Delaware corporate jurisprudence was truly a two-pronged analysis; at a minimum, they would have been justified in doubting the equal significance of fair process and fair price in the eyes of the court. After *Nine Systems*, these doubts appear to have receded. But what then explains the difference in result in these two cases and how can they be reconciled? What distinctions can be drawn and what lessons can be learned to properly guide director behavior in the future?

In the end, the overarching difference in these two cases may simply be a matter of degree of misconduct by the defendant directors. In *Trados*, the defendant directors clearly acted in the best interests of their respective investment firms and the process they employed to approve the sale of the company may have been flawed. But no truly egregious forms of misconduct were present and the resulting transaction was an exit that resulted in a partial loss of investment capital for the company's venture capital investors. By way of contrast, the defendant directors in *Nine Systems* staged a self-interested recapitalization of the company while freezing out a fellow director and disenfranchising the common stockholders in the process. Moreover, this conduct ultimately led to a very positive result for the company's preferred stockholders at exit with certain investors enjoying a 2,000% rate of return in connection with the *Akamai* transaction.

Regardless of the bases for distinguishing these two court decisions, *Nine Systems* provides a reminder of some practical considerations for investor directors to bear in mind in the course of carrying out their fiduciary duties as board members:

1. <u>Process is (apparently still) important</u>. The court in *Nine Systems* criticized the process by which the Board approved the Recapitalization, finding that the Board had not dealt with the company's common stockholders in a procedurally fair manner. In the context of a proposed sale of a corporation, boards of directors should take steps to consider the interests of common stockholders and create a process that gives voice to common stockholder considerations. This process can include (i) establishing an independent, special committee of the board of directors to review and approve the terms of a proposed sale, (ii) obtaining a fairness opinion from an investment bank or a qualified, third party valuation firm and/or (iii) conditioning the closing of the sale on the vote of a majority of disinterested common stockholders. Documenting these steps in the form of corporate minutes is also important. Following these procedures may allow investor directors to avail themselves of the protections of the business judgment rule and the more deferential level of judicial review that comes with it.
2. <u>Director "interest" in a transaction will be narrowly construed</u>. 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.

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 rule presupposes that the board of directors is comprised of a majority of independent, disinterested directors; as seen in *Nine Systems*, 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.

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

Footnotes.

1. "The concept of fairness has two aspects: fair dealing and fair price. [Fair dealing] embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors were obtained. [Fair price] relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." *Weinberger v. UOP, Inc.* 457 A.2d 701 (Del. 1983).

2. *In re Trados Inc. S'holder Litigation*, 73 A.3d 17 (Del. Ch. 2013).

3. *In re Nine Systems S'holder Litigation*, 2014 WL 4383127 (Del. Ch. Sept 4, 2014).