# Securities Regulation Daily Wrap Up, MERGERS AND ACQUISITIONS—Del. Ch.: Fair price fails to overcome 'grossly inadequate' recapitalization process, (Sep. 10, 2014)

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By Anne Sherry, J.D.

Under the "contextual" entire fairness doctrine, a recapitalization that diluted some shareholders' equity through a "grossly unfair" process was not entirely fair even though the price was more than fair. The Delaware Chancery Court's holding that the defendants breached their fiduciary duties may be small comfort to the plaintiffs, who were denied a damages award but may be able to recover attorney's fees (*In re Nine Systems Corporation Shareholders Litigation*, September 4, 2014, Noble, J.).

**Background.** In 2002, Streaming Media Corporation, later Nine Systems Corporation, undertook a recapitalization in which several of the director defendants increased their equity, correspondingly diluting the equity of the plaintiff shareholders who were not aware of the recapitalization until after it had been implemented. Four years later, the company sold itself to Akamai Technologies, Inc. for approximately $175 million. The plaintiffs brought direct breach of fiduciary duty, aiding and abetting, and unjust enrichment claims on the basis that the defendants unfairly expropriated the economic and voting rights of the company's stockholders who did not participate in the recapitalization.

**Standing.** The court devoted nearly half of its written opinion to the question of whether the plaintiffs had standing to bring their direct claims, which it answered in the affirmative. Under the Delaware Supreme Court's opinion in *Gentile v. Rossette (Gentile II)*, the plaintiffs could establish direct standing by proving that the three defendants that benefited from the recapitalization (and at the time collectively owned 54 percent of the company's stock and 90 percent of its senior debt) constituted a control group — the functional equivalent of a controlling stockholder — during the recapitalization. In this case, the members of the control group would owe fiduciary duties to other stockholders, creating a basis for direct standing to challenge their conduct. Alternatively, the plaintiffs could also establish standing by proving that a majority of the board was interested or not independent when it approved and implemented the recapitalization.

The court concluded that the three defendants did constitute a control group, ultimately based on one of the defendants' 90-day informal right to invest in what would become the Preferred B-1 stock. This right to invest was not disclosed to the entire board, and it was provided only to the other shareholder whose cooperation would be required to approve certain charter amendments by stockholder written consent instead of at a special meeting. The weight of the evidence thus supported the inference that the right to invest was given in exchange for an agreement to support the recapitalization. This, in turn, demonstrated "an agreement, arrangement, and legally significant relationship" among the three parties that subjected them to fiduciary duties.

As an alternative basis for standing, the court interpreted *Carsanaro v. Bloodhound Technologies* as supporting standing for stockholders to challenge an expropriation by a board of directors after a merger, just as they have standing to challenge an expropriation by a controlling stockholder. Under this analysis, the plaintiffs established their standing by proving that a majority of the directors who approved the recapitalization suffered under the "dual-fiduciary problem" wherein their fiduciary duties to the stockholders who benefited from the recapitalization necessarily conflicted with their duties to the stockholders who did not.

**Entire fairness.** The Chancery Court warned that "entire fairness is the most onerous standard of review in Delaware corporate jurisprudence" due to the court's need to reach a unitary conclusion on both fair dealing and

fair price, or procedural and substantive fairness. There is no bright-line rule on what is entirely fair; rather, the standard of review is contextual.

In this case, the court found credible evidence that the company's implied equity value going into the recapitalization was negative, so that the plaintiffs' stock had zero value. This compelled the court to conclude that the recapitalization was approved at a fair price; regardless of how much the plaintiffs may have been diluted, they necessarily received the substantial equivalent in value of what they had before.

"Concluding that the Company's equity had no value before the Recapitalization compels the Court also to conclude, as this Court recently did in In re Trados Inc. Shareholder Litigation , that the Recapitalization was approved by the majority -- conflicted Board at a fair price. Regardless of how much the Plaintiffs may have been diluted in the Recapitalization, because their common stock had no value that could have been diluted, the Plaintiffs necessarily "received the substantial equivalent in value of what they had before."

But the court found that the transaction was not entirely fair because the recapitalization process was "grossly inadequate." "If the oft-repeated holding of the Delaware Supreme Court's decision in *Weinberger* … that the analysis is *not bifurcated* but is to be a *unitary conclusion* has any purchase," the court noted, "it must hold true that a grossly unfair process can render an otherwise fair price, even when a company's common stock has no value, not entirely fair."

**Damages.** Although the plaintiffs prevailed on both their fiduciary duty and aiding-and-abetting claims, the court declined to award damages. The company's charter contained an exculpatory provision that shielded the directors from damages liability for breaching the duty of care. Although the duty of loyalty and aiding-and-abetting components were in theory eligible for damages, in the court's discretion, monetary damages were inappropriate because the unfair recapitalization was effected at a fair price in which the plaintiffs' stock had no value.

Nevertheless, the court also exercised its discretion, its equitable power to shift attorney's fees and its statutory authority to shift costs and invited the plaintiffs to petition the court for a fee award.

**Fraud claim.** Finally, the court entered judgment in favor of the defendants on a fraud claim by one of the company's earliest investors. Several months before the merger, the company repurchased stock from the plaintiff for $1 per share. The court concluded that there was no duty to disclose the merger discussions and, therefore, there was no fraud based on a failure to disclose.

The case is No. 3940-VCN.

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Companies: Wren Holdings; Javva Partners; The Cameron Family Partnership; Catalyst Investors; Nine Systems Corp.

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