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Delaware Insider:

Private Company Financings: Delaware Court Provides Guidance for Boards and Venture Funds

By Jeffrey R. Wolters

A common fact pattern for venture-backed companies is the emergency "inside round": the company is running out of cash, new investors have not been found, and therefore the current backers – that is, the venture funds that likely control a majority of the company's stock and a majority of its board seats – agree to invest additional capital. This used to be a fact pattern that was well known in the market, but had rarely been seen in the Delaware courts. That has changed in recent years, as the Delaware courts have by now decided several notable cases concerning inside rounds – and in particular the fiduciary duties of boards in approving them.

The recent decision of the Delaware Court of Chancery in *In re Nine Systems Corporation Shareholders Litigation*, Consol. C.A. No. 3940-VCN (Del. Ch. Sept. 4, 2014), is especially instructive for private company directors, investors, and the lawyers who advise them. The case was highly critical of the process followed by directors and their VC affiliates in connection with an inside round. However, by pointing out in detail the defects in the process, the court also created a road map for running a better process and protecting directors and VCs in the future. The court also showed once again that Delaware courts are sophisticated in their analysis of valuation questions and willing to recognize that an inside round, particularly for a struggling company, may have been priced fairly even though the directors and VCs faced conflicts.

The *Nine Systems* Case

The case involved a two-year-old startup company that needed additional financing to continue operations and make acquisitions. Three venture funds designated a majority of the company's board and held a majority of its outstanding stock and debt. Two of these three agreed to invest – by buying new preferred stock and converting prior debt into stock – and the third was given the opportunity to invest. The investment was based on a $4 million valuation of the company. One consequence of the investment was that the percentage of stock owned by the company's minority stockholders decreased from 26 percent to 2 percent. Another consequence was that, eventually at least, the company turned around. It made the two acquisitions and, four years later, was acquired in a merger for $175 million.

After receiving the proxy statement for the merger, which disclosed the impact of the prior financing, the company's founder and certain other minority stockholders brought suit. They did not attack the merger, but rather the financing. They argued that because the opportunity to buy preferred stock in the financing was offered only to the venture firms that designated a majority of the board, the financing was a conflict transaction and therefore subject to the rigorous "entire fairness" test under Delaware law. Under that test, if a majority of the board has a conflict of interest in approving a transaction, or if the transaction is with a controlling stockholder or control group (which the plaintiffs also argued), then the defendants must prove that the transaction was entirely fair to the minority, both in terms of the procedure leading up to the transaction and the ultimate substance (i.e., price and terms) of the transaction. If the defendants cannot satisfy this test, then they are deemed to have breached their fiduciary duty of loyalty and may owe personal damages. It was on this basis that the case went to trial, resulting in a 146-page ruling in September.

The Court's Ruling, and a Road Map for Better Process

The court's ruling focused on a detailed application of the entire fairness test – both procedurally ("fair dealing") and substantively ("fair price"). The court ultimately found that the challenged financing was fair in terms of price, but that because the process leading up to the transaction was so "grossly unfair," the directors had breached their fiduciary duties and did not satisfy the entire fairness test.

Fair Dealing

The court's conclusion concerning the lack of procedural fairness was based on several factors. In pointing out what went wrong, the court implicitly offered a road map for getting it right.

Participation by the Independent Director

Although three of the company's five directors were conflicted, it did have one clearly independent director who was affiliated with the minority shareholder group. However, this director did not play a significant role in considering the transaction. Indeed, the court concluded that the rest of the board, rather than ensuring that this director was fully informed and involved, actually took steps to exclude him from the process (such as by holding meetings at times when they knew he could not attend and generally not keeping him informed). Further, at one point the director said he would approve the transaction subject to certain changes being made to benefit the minority; the board accepted his "yes" vote but did not follow through with the changes.

One comment by the court suggests a better path: "Biderman was independent, but there was no effort to condition the [transaction] on his approval or that of disinterested stockholders." Taking this one step further, the board also could have appointed the independent director as an independent committee. The use of independent committees is less common for private companies than for public companies, partly due to the perceived delay and expense of a committee process. But *Nine Systems* repeatedly emphasized the importance of a "contextual" approach to assessing whether a given process was fair. This suggests that a court would appreciate the contextual exigencies of a private company liquidity crisis – and would give credit for running a credible independent committee process even if it lacked all the trappings of a public company process. Such a process (i.e., one that was as good as practicable in the context) should, at a minimum, be strong evidence of fairness, even if it might not always have the full doctrinal effect of triggering the business judgment rule. One recent case did find that the business judgment rule applied to protect a private company transaction with its majority stockholder, where a committee process was coupled with a minority stockholder vote. *Swomley v. Schlecht*, C.A. No. 9355-VCL (Del. Ch. Aug. 27, 2014) (Transcript).

Finally, the court also found that the board misunderstood its fiduciary duties. The board apparently believed that the independent director was the one charged with looking out for the minority stockholders. All directors owe duties to all stockholders, the court corrected, while noting that the board's misunderstanding of its duties was itself evidence of an unfair process. Presumably this problem can be avoided in most deals in the future so long as counsel takes care to inform the directors of their duties.

Valuation

The court next found that an unfair process was shown by the fact that the board did not have explained to it or understand the valuation that drove the pricing of the challenged financing. The valuation was not prepared by the board, management, or an outside financial advisor, but rather by a principal of one of the venture investors. The court implicitly suggested two fixes. First, the valuation could have been explained to the board, with minutes summarizing the discussion and demonstrating the board's contemporaneous understanding and adoption of the valuation. Second, an outside financial advisor could have been consulted. The court noted that this was not required by Delaware law, but would often be strong evidence that the board was adequately informed concerning valuation. A middle course seems clear as well: obtain a written valuation analysis from management and build a record that the board fully understood it and concluded it was the best available valuation.

Rights Offering

The court next considered that the right to participate in the financing was offered only to the funds affiliated with the board majority, and was not effectively disclosed or offered to other stockholders. Prior Delaware cases have found that if a financing opportunity is offered pro rata to all stockholders, that generally will cleanse the conflict posed by an otherwise "inside" round. The court in *Nine Systems* reiterated this view, stating that a director "who approves a stock issuance *not offered to all stockholders* may, if he or she is in a fiduciary relationship with a recipient of the new stock, faces an inherent conflict of interest." Thus, in future transactions, use of a rights offering should be considered as a way to eliminate a conflict of interest, or, at the least, stand as strong evidence of fair process.

Disclosure

The court also found "powerful evidence of unfair dealing" in the board's failure to inform stockholders concerning the financing, particularly in a notice that was sent at the time. That notice informed stockholders that the financing had occurred, but did not disclose who participated and on what terms. The solution to this problem next time is clear: full and fair disclosure.

Changed Terms

Finally, the court also found evidence of unfair dealing in the fact that certain terms of the financing were changed, to benefit the investors, following the board's approval of the financing. Putting aside whether the final terms of the financing were even duly authorized, the fix next time is apparent: obtain board approval of the final terms.

Unitary Analysis and Fair Price

Based on the factors discussed above, the court found a "grossly unfair process." But it came out differently on the important second prong of the entire fairness test, "fair price." As with its analysis of the process, the court took a highly "contextual" approach. First, it recognized that fair price was not a single number, but instead a range. Second, and crucially, it recognized that while price issues would often be assessed based on valuation methods that relied on a company's projections (such as the discounted cash flow method), those methods were not persuasive if a company's projections were not reliable. That was the case in *Nine Systems*, where the company had only one year of forward projections, and had consistently and widely missed its projections in the past. The court thus agreed with the defendants' expert witness that the best way to value the company was not based on its forecast, but rather based on last 12 months revenue multiples for comparable companies. The court also found that it was appropriate to apply a "private company discount" to those multiples. The court ultimately concluded that the pricing of the challenged financing was fair because, based on the best valuation evidence before the court, the company's stock had no value at the time of the financing.

The Upshot

Because the price was fair, no damages were awarded, even though the process was unfair. This is the same result as the much-noted *Trados* decision last year. *In re Trados Inc. Shareholder Litigation*, 73 A.3d 17 (Del. Ch. 2013). Importantly, however, the court in *Nine Systems* also noted that a particularly bad process could "infect" a court's consideration of price fairness. Thus, while fairness of price may still be the preponderant consideration in such cases – and the main factor in assessing whether damages are awardable – the process can, at a minimum, influence the price analysis. Moreover, because they had shown such an unfair process, the plaintiffs in *Nine Systems* were invited to apply for attorneys' fees.

In the future, boards and their venture backers should be able to mitigate lawsuit risk by establishing a record, up front, of the type of valuation considerations credited by the court in *Nine Systems* and by addressing the procedural elements that undermined the board's ability to demonstrate fair dealing.

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ADDITIONAL RESOURCES
For other materials related to this topic, please refer to the following.

Business Law Today

Side-Stepping Fiduciary Issues in Negotiating Exit Strategies for Preferred Stock Investments after Trados
By Lisa R. Stark
September 2013