Court Finds Emergency Inside Round Unfair

By William E. Sigler

The court in *In re Nine Systems Corp. Shareholders Litigation,* C.A. No. 3940-VCN (Del. Ch. Sept. 4, 2014) recently found three venture funds and the directors they appointed liable for breach of fiduciary duties in connection with the recapitalization of a corporation that was running out of cash. Although the court found the recapitalization process to be "grossly unfair," it declined to award damages, partly because it found the price to be fair and partly because the damages sought by the plaintiffs were found to be too speculative.

Factual Background

The case involved a start-up company called Streaming Media Corporation, which later changed its name to Nine Systems Corporation. The company was founded in 1999 in the midst of the dot-com boom to take advantage of streaming-media technology. The recapitalization occurred two years later.

In *Nine Systems,* the company's board of directors approved a recapitalization plan that involved the conversation of certain secured debt into a new class of preferred stock and the issuance of a new class of convertible preferred stock in exchange for new investment capital to finance acquisitions. The board consisted of five members, including the CEO and three designees of a group of investors who owned 54% of the company's stock and held more than 90 percent of the company's senior debt. The recapitalization plan had the effect of significantly diluting the minority stockholders.

A principal of one of the interested investors valued the company at $4 million at the time of the recapitalization. In contrast, the court found the company to have a value of zero. However, as a result of the recapitalization, the company was able to acquire new businesses, and four years after the recapitalization the company was sold for $175 million. The lawsuit by the minority investors was filed after the company was sold and ensued for the next six years.

The Court's Ruling

The court applied a fairness test that consisted of two parts. The first part concerned whether the process involving the recapitalization was fair. The second part involved whether the price was fair. Because the process leading up to the recapitalization was “grossly unfair,” the court found that the interested directors had breached their fiduciary duties and did not satisfy the fairness test.

There are several factors that led to the court’s conclusion:

- The interested directors failed to keep the independent director fully informed and actually took steps to exclude him from the process, e.g., by holding meetings at times when they knew he could not attend.
- The independent director said that he would approve the transaction subject to certain changes being made to benefit the minority investors and the interested directors accepted this proposal, but did not follow through with the changes.
- The board apparently did not understand the valuation that drove the pricing of the recapitalization. The valuation was not prepared by the board or by management or an outside valuation expert, but rather by a principal of one of the interested investors.
- The right to participate in the recapitalization was offered only to the venture funds affiliated with the interested directors and was not effectively disclosed or offered to the other investors.
- The court found “unfair dealing” in the board’s failure to inform the minority investors concerning the financing, particularly in a notice that was sent advising the minority investors that the financing had occurred, but without disclosing who participated and on what terms.
- Certain terms of the financing were changed to benefit the interested investors after the board’s approval of the recapitalization.

Lessons To Be Learned

Nine Systems illustrates the risks for investment funds that comprise a control group with fiduciary duties or which could be liable for aiding and abetting directors who breach their fiduciary duties. It also highlights the importance of appraisals or other credible expert testimony in demonstrating the fairness of a valuation. Above all, *Nine Systems* demonstrates the importance of a process that is fair to all investors from the outset of a transaction, since there is a risk that the board’s actions, even at the earliest stages of a transaction, will be examined in hindsight during litigation occurring many years later.