

Chancery Court Finds Venture Capital Investors Collectively Constitute a Controlling Stockholder

In *Zimmerman v. Katherine D. Crothall et al.*, C.A. No. 6001-VCP (Del. Ch. Mar. 27, 2012), the Delaware Court of Chancery found that certain commonalities often shared by venture capital investors supported a reasonable inference that two venture capital investors in Adhezion Biomedical LLC (“Adhezion”) were a controlling stockholder group. As a result, the transactions at issue in which the investors received additional interests in Adhezion were held to be subject to entire fairness review.

Adhezion is an early-stage medical products company with two principal venture capital investors who hold preferred units: Liberty Ventures II, L.P. (“Liberty”) and Originate Ventures, LLC (“Originate” and, together with Liberty, the “VC Investors”). The VC Investors jointly possess more than 66% of Adhezion’s voting power and their representatives hold two of five seats on Adhezion’s board. Plaintiff, a co-founder and former CEO of Adhezion, alleged that Adhezion’s directors (aided and abetted by the VC Investors) breached their fiduciary duties of care and loyalty in approving a number of transactions in which the VC Investors made additional investments in the cash-strapped company on terms not offered to Adhezion’s common unitholders. The defendants moved for summary judgment on all counts.

The Court commenced by finding that plaintiff had failed to meet his burden of pleading with respect to the duty of care claims – i.e., the evidence did not show that the Adhezion board acted irrationally or recklessly in its capital raising efforts. The board contacted over 40 potential investors in a seven-month period and considered a range of funding options, including licensing deals and the sale of the entire company, before it approved the challenged transactions with the VC Investors.

However, the Court denied defendants’ motion for summary judgment on plaintiff’s duty of loyalty claims. Specifically, the Court found that the defendants had approved self-dealing transactions in which a controlling stockholder received additional equity interests in the company on terms that were not available to the common unitholders. In reaching the conclusion that the VC Investors jointly constituted a controlling stockholder, the Court focused on the fact that Originate and Liberty were Adhezion’s two largest investors, had invested in Adhezion at around the same time and each had one designee on the board. Further, the Court looked to e-mails and board minutes in which the VC Investors communicated similar concerns and solutions with respect to Adhezion’s capital raising efforts as evidence that they were acting in concert with respect to, and exercising actual control over, such efforts.

The Court also found that the challenged transaction constituted an interested transaction because a majority of the members of the board participated in the financings at issue. Accordingly, at trial, defendants would have to prove that the challenged transactions met the exacting entire fairness standard.

Delaware Supreme Court Affirms Superior Court Decision Interpreting Preferred Stock.

Alta Berkely VI C.V. et al. v. Omneon, Inc., C.A. No. N10C-11-102 JRS CCLD, 2011 Del. Super. LEXIS 321 (Del. Super. July 21, 2011), *aff'd*, 2012 Del. LEXIS 142 (Del. Mar. 5, 2012), the Delaware Superior Court found that defendant, Omneon, Inc. ("Omneon"), did not violate its certificate of incorporation by using a forced conversion provision to avoid paying the holders of its Series C-1 preferred stock their liquidation preference in connection with Omneon's acquisition by Harmonic, Inc. ("Harmonic").

In May 2010, Omneon entered into a merger agreement to be acquired by Harmonic for approximately \$190 million in cash and \$120 million in stock. One of the conditions to the merger was that all but one of Omneon's nine series of preferred stock, including the Series C-1 preferred stock, would be converted into common stock pursuant to a forced conversion provision in Omneon's certificate of incorporation immediately prior to the merger. The forced conversion provision provided for the automatic conversion of all series of Omneon's preferred stock upon the vote of a majority in voting power of the outstanding series of preferred stock subject to an opt-out right held by the holders of Series A-2.2 preferred stock. Plaintiffs' stock was converted into common stock prior to the merger, and common holders received a mix of cash and Harmonic stock in the merger valued at approximately \$11.00 per share.

Plaintiffs argued that they were entitled to receive their liquidation preference of \$28.78 per share, not the \$11.00 per share in cash and stock that they received as holders of common stock. The focus of plaintiffs' argument was a provision in Omneon's certificate of incorporation that entitled them to their liquidation preference in the event that "a series of related transactions" resulted in a change in voting control of Omneon (a "Liquidation Event"). It was undisputed that the merger constituted a Liquidation Event; however, plaintiffs argued that the automatic conversion was also part of a Liquidation Event. The Court disagreed with plaintiffs and found that a reasonable third party would view the conversion as a condition, but not part of a "series of related transactions" that comprised the merger itself. The Court also noted that the opt-out right to the automatic conversion held by the holders of the Series A-2.2 stock would be rendered meaningless if the certificate of incorporation were effectively construed to give the plaintiffs the right to opt out from an automatic conversion. Accordingly, the Superior Court granted defendant's motion for summary judgment.

On appeal, the Delaware Supreme Court held that under the plain meaning of Omneon's unambiguous charter language, the Delaware Superior Court ruled correctly. First, the conversion was not a part of a Liquidation Event because the conversion was not a transaction in which Harmonic received any voting power in Omneon. In other words, under Omneon's certificate of incorporation, a Liquidation Event occurred if there was a shift in majority voting power of Omneon, and the merger was the only transaction pursuant to which Harmonic acquired any voting power in Omneon. Second, the conversion validly converted the Series C Preferred Stock into common stock prior to the effective time of the merger. In order to be entitled to their liquidation preference, the former Series C preferred stockholders must have held preferred stock at the time of the merger—they did not.

Chancery Court Upholds Forced Conversion Feature

In Greenmont Capital Partners I, LP v. Mary's Gone Crackers, Inc., C.A. No. 7265-VCP (Del. Ch. Sept. 28, 2012), the Delaware Court of Chancery dismissed a claim that sought to unwind the conversion of plaintiff's preferred stock into common stock, where the defendant's certificate of incorporation specifically authorized the conversion at issue. The certificate of incorporation of Mary's Gone Crackers, Inc. ("MGC") contained a provision that triggered an automatic conversion of all of the corporation's preferred stock into common stock upon the affirmative vote of the holders of a majority of the outstanding Series A preferred stock and Series B preferred stock, voting together as a class. On February 17, 2012, MGC received the requisite consent of its preferred stockholders for the conversion and, following the effectiveness of the conversion, proceeded to amend its certificate of incorporation to eliminate the provisions of its certificate of incorporation which related to its previously outstanding preferred stock. MGC did not seek the vote of any MGC stockholder in connection with the elimination of the preferred stock terms, by amending the charter of MGC, as permitted by Section 151(g) of the General Corporation Law of the State of Delaware (the "DGCL").

Plaintiff, a former holder of Series B preferred stock, argued that the forced conversion and subsequent elimination of the preferred stock terms were unlawful without a separate class vote of the holders of Series B preferred stock under Section D.2(b) of MGC's certificate of incorporation ("Section D.2(b)"). Prior to its elimination, Section D.2(b) required MGC to obtain the vote of the holders of Series B preferred stock prior to effecting "any agreement or action that alters or changes the voting rights or other powers, preferences or other special rights" of the Series B preferred stock. The Court found that Section D.2(b) did not provide the holders of Series B preferred stock with a blocking right in connection with the conversion of the preferred stock or subsequent elimination of the terms of the preferred stock from MGC's certificate of incorporation.

According to the Court, Section D.2(b) did not limit the application of the automatic conversion provision because the automatic conversion provision was itself a special right of the holders of MGC's preferred stock. In other words, the conversion was effected by the exercise of an existing right of the holders of preferred stock, not the alteration or change of any right. The Court also held that Section D.2(b) did not limit MGC's authority to eliminate the preferred stock terms under the DGCL because the Series B preferred stock was not outstanding at the time of the charter amendment.

Chancery Court Addresses Appraisal of Preferred Stock.

In *Shiftan et al. v. Morgan Joseph Holdings, Inc.*, C.A. No. 6424-CS (Del. Ch. Jan. 13, 2012), the Delaware Court of Chancery granted summary judgment in favor of petitioners on the issue of whether a mandatory redemption provision, which provided for an automatic redemption of preferred stock six months following a merger giving rise to appraisal rights, was required to be taken into account in the Court's determination of the "fair value" of the preferred stock. Unlike common stock, the value of preferred stock in an appraisal proceeding is determined solely by reference to the contract rights conferred upon it in the certificate of incorporation. Here, the preferred stock would have been redeemed for \$100 per share, just six months after the merger giving rise to appraisal rights, pursuant to a specific, non-speculative, contractual right, which the Court determined was an important economic factor bearing on the value of the preferred stock as of the date of the merger.

Chancery Court Holds Liquidation Value of Preferred Stock Irrelevant to Valuation of Common Stock in a Statutory Appraisal Action

In *In re Appraisal of The Orchard Enterprises, Inc.*, C.A. No. 5713-CS (Del. Ch. July 18, 2012), the Delaware Court of Chancery rejected respondent's argument that the value of the liquidation preference of its preferred stockholders should be deducted from respondent's enterprise value when determining the value of the corporation's common stock in an appraisal proceeding because the merger at issue did not constitute a liquidation event under respondent's certificate of incorporation.

In July 2010, The Orchard Enterprises, Inc. ("Orchard") effected a going-private merger with its controlling stockholder, Dimensional Associates, LLC ("Dimensional"). Orchard's common stockholders were cashed out at a price of \$2.05 per share. The merger did not constitute a deemed liquidation entitling Orchard's preferred stockholders to their liquidation preference under Orchard's certificate of incorporation because it was a related party merger, and Orchard's preferred stock remained outstanding at the effective time of the merger. In this statutory appraisal action brought by holders of Orchard common stock, Orchard argued that the

value of the preferred stockholders' liquidation preference should be deducted from the enterprise value of Orchard when calculating the value of its common stock. According to Orchard, Dimensional, as the holder of a majority of the outstanding preferred stock, could demand its liquidation preference as a precondition to any future merger with an unrelated party. The Court found Orchard's arguments unpersuasive because: (1) the issue of whether the liquidation preference may be triggered in the future was a matter of speculation as of the going-private merger date, and (2) under settled law, the petitioners were entitled to receive their pro rata share of the value of Orchard as a going concern in an appraisal proceeding—not its liquidation value.

Chancery Court Invalidates Super-Voting Preferred Stock

In *Keyser v. Curtis*, C.A. No. 7109-VCN (Del. Ch. July 31, 2012), the Delaware Court of Chancery held invalid the creation and issuance of super-voting preferred stock by the sole director of Ark Financial Services, Inc. ("Ark"), an affiliate of Dawson James Securities, Inc. ("Dawson James"), because the director issued the stock to himself for nominal consideration and for the primary purpose of preventing Ark's stockholders from electing a new board.

This action arose from a dispute over control of Ark by its founders: Robert D. Keyser ("Keyser") and Albert Poliak ("Poliak"). In 2009, Keyser stepped down as CEO of Dawson James and as a director of its parent company, Ark, at the request of Ark's creditors. Poliak became the sole director of Ark and also replaced Keyser as CEO of Dawson James. Subsequently, Keyser developed a plan to remove Poliak and elect himself and his allies to the Ark board by purchasing notes and an option to acquire a substantial portion of Ark's common stock from Ark's creditors. In response, Poliak created and issued himself a sufficient number of shares of a new series of super-voting, Series B preferred stock to dilute the stockholdings of Keyser and his allies below a majority of the outstanding voting power. After settlement negotiations failed, the Keyser faction purported to remove Poliak by an action by written consent of the holders of a majority of the outstanding common stock. Keyser and his allies then initiated an action pursuant to Section 225 of the General Corporation Law of the State of Delaware to determine the lawful directors of Ark.

In this post-trial decision, the Court determined that plaintiffs' action by written consent was effective to remove Poliak as a director because the Series B preferred stock was void and plaintiffs' consent therefore represented a majority of the outstanding voting power of Ark. In reaching the conclusion that the Series B preferred stock was void, the Court found that the issuance was the product of self-dealing. Poliak argued that the dilutive issuance was justified because Ark faltered under Keyser's leadership and would suffer even greater financial distress if Keyser regained control of the company. The Court held that even if true, these facts failed to establish the entire fairness of Poliak's decision to give control of the company to himself for

nominal consideration and intentionally deprive Ark's stockholders of the right to determine who should comprise the Ark board.

Chancery Court Finds Director Breached Duty of Confidentiality but Declines to Award Damages or Attorney Fees

In *Shocking Technologies, Inc. v. Michael*, C.A. No. 7164-VCN (Del. Ch. Sept. 28, 2012), the Delaware Court of Chancery found that a director and stockholder of a Delaware corporation breached his duty of loyalty to the corporation by interfering with the cash-strapped corporation's efforts to obtain funding and by disclosing confidential corporate information to potential investors in an effort to increase his control over the corporation. However, the corporation was unable to show that it suffered any loss as a result of the breaches of fiduciary duty. In addition, the Court found that the director subjectively believed that his actions were in the best interests of the corporation. Accordingly, the Court declined to award the plaintiff damages or attorneys' fees.

Chancery Court Considers Contractual Limitations on Post-Closing Indemnification Claims Related to Alleged Breaches of Representations and Warranties

In *Impact Investments Colorado II, LLC and Baker Investment Trust v. Impact Holding, Inc.*, C.A. No. 4323-VCP (Del. Ch. Aug. 31, 2012), the Delaware Court of Chancery held that the terms of a stock purchase agreement precluded the buyer of a candy manufacturing business from seeking indemnification for certain claims that had been the subject of post-closing negotiations between the parties and had resulted in a post-closing adjustment to the purchase price.

This action arose from the acquisition of all of the outstanding stock of Impact Confections, Inc. ("Impact") by Brazos Private Equity Partners LLC ("Brazos" or "Buyer"). In 2008, the holders of all of the outstanding capital stock of Impact ("Sellers") entered into a stock purchase agreement (the "SPA") with Brazos. The SPA provided for a post-closing purchase price adjustment in the event that Impact's target working capital on the closing date differed from its actual working capital as of such date. In this connection, the SPA required Buyer to deliver to Seller a statement setting forth the actual working capital of Impact within sixty days of closing and provided a procedure for resolving post-closing purchase price disputes. In addition, the SPA created an escrow account from which claims for indemnification for breach of representations and warranties concerning Impact would be paid within one year of closing. Finally, Section 6(f) of the SPA ("Section 6(f)") limited the Buyer's ability to seek indemnification for claims taken into account in determining purchase price adjustments, stating that "Sellers shall not be obligated to indemnify Buyer against Adverse Consequences as a result

of, or based upon or arising from, any claim or liability to the extent such claim or liability is taken into account in determining any adjustment to the Purchase Price.”

In this case, Buyer argued that Section 6(f) did not foreclose it from pursuing indemnification for expenses which resulted in a purchase price adjustment to the extent the amount sought to be indemnified differed from any post-closing adjustments to the purchase price. The Sellers argued that Section 6(f) should not be interpreted in a manner that allowed Buyer to rehash disputes negotiated and settled through a purchase price adjustment. The Court agreed with Sellers and granted summary judgment in favor of Sellers with respect to several disputed expenses that had resulted in purchase price adjustments. However, the Court declined to grant Sellers’ motion for summary judgment on a number of Buyer’s remaining claims for indemnification relating to alleged errors in the calculation of the components of working capital which had not been actually disputed and negotiated during the purchase price adjustment process. The Court believed that the resolution of these latter claims could only be resolved after trial.

Chancery Court Finds Delivery of Notice on a Stockholder Representative Is Effective as to All Stockholders

In *Pryor v. IAC/InterActiveCorp*, C.A. No. 6884-CS (Del. Ch. June 7, 2012), the Delaware Court of Chancery held that the delivery of notice of an arbitral award to a person appointed as a stockholder representative under a stockholders’ agreement was effective notice as to the other stockholder parties to the agreement. The stockholders’ agreement did not contain an express provision designating the stockholder representative as the other stockholders’ attorney-in-fact for all matters arising under the agreement. However, the stockholders’ agreement did confer exclusive authority on the stockholder representative to decide whether and when to exercise, on behalf of all stockholder parties to the agreement, the put right at issue in this case. In addition, the stockholders’ agreement granted the stockholder representative the exclusive role to act on behalf of the other stockholders in valuation and arbitration proceedings arising from the exercise of the put right. Accordingly, the Court found that service of notice of an arbitral award on the stockholder representative was effective notice on all stockholder parties for purposes of determining the timeliness of plaintiff’s challenge to an arbitral award arising from the stockholder representative’s exercise of the put right.

Chancery Court Orders Viacom to Release Escrowed Merger Consideration

In *Winshall v. Viacom International Inc.*, C.A. No. 6074-CS (Del. Ch. Dec. 12, 2012), the Delaware Court of Chancery ordered Viacom International Inc. (“Viacom”) to release merger consideration held in escrow since 2006 for the benefit of the former stockholders of Harmonix Music Systems (“Harmonix”), a developer of music-based video games. Following the closing

of its acquisition of Harmonix, plaintiff repeatedly requested that Viacom release the escrowed funds for distribution to Harmonix's stockholders pursuant to the terms of the parties' merger agreement. Viacom refused to release the funds on the basis that it had a claim to all of the escrow funds pursuant to a provision in the merger agreement that entitled it to indemnification for legal fees from the escrow funds if Harmonix breached its representations and warranties and the breach caused Viacom to incur legal fees. According to Viacom, Harmonix breached representations and warranties relating to Rock Band, a video game which Harmonix was still developing at the time of the execution of the merger agreement. Specifically, Harmonix represented that it had "adequate [intellectual property] rights" for the "current use" of "any [g]ames in development." After Viacom released Rock Band in 2007, several parties sued Viacom and alleged that the final, published version of Rock Band infringed their intellectual property rights.

In December 2010, plaintiff, as the stockholders' representative under the parties' merger agreement, initiated this action and sought to force Viacom to release the escrow funds. Viacom defended this action on the basis that it was entitled to be indemnified out of the escrow funds for its legal fees incurred in defending claims related to Rock Band. In determining whether Viacom had any entitlement to indemnification from the escrow funds for its defense costs, the Court reviewed the plain terms of the merger agreement. According to the Court, the merger agreement permitted Viacom to be indemnified for defense costs only if the costs arose from an actual breach of Harmonix's representation and warranties. Because the patent infringement actions all related to the final, published version of Rock Band, as to which Harmonix made no representations in the parties' merger agreement, the Court found that Harmonix had not breached the merger agreement, and Viacom was therefore not entitled to indemnification from the escrow funds.

Chancery Court Holds That Rights Associated with Debt Instruments May Not Be Unilaterally Eliminated in a Merger.

In *Dawson v. Pittco Capital Partners, L.P.*, C.A. No. 3148-VCN (Del. Ch. Apr. 30, 2012), the Delaware Court of Chancery ruled that notes held by certain investors in a start-up company, LaneScan LLC ("LaneScan"), were not cancelled in the merger of the company with Vehicle Safety and Compliance, LLC ("VSAC") on the basis that, unlike rights attendant to stock, rights associated with debt instruments may not be eliminated in a merger without the express consent of the holders thereof.

In 2004, plaintiffs purchased units of LaneScan. Each unit purchased by plaintiffs consisted of a preferred interest in LaneScan and a secured note of the company. By 2006, LaneScan had run out of money and agreed to be acquired by VSAC, a company in which some of LaneScan's investors also held interests. Plaintiffs were asked by LaneScan's Chairman to

contribute their secured notes to VSAC in connection with the merger, but they refused. At the effective time of the merger, plaintiffs' notes were allegedly cancelled and their preferred interests severely diluted.

In this action, plaintiffs challenged, among other things, the involuntary cancellation of their notes. Defendants argued that they could force the cancellation of plaintiffs' notes in a merger regardless of whether any operative agreement addressed the issue and, in any event, a drag along provision in LaneScan's limited liability company agreement authorized the cancellation. In support of their first argument, defendants relied on decisions holding that "vested rights" of stockholders, such as dividend, voting and other rights, could be eliminated in a merger. The Court noted that the decisions relied upon by defendants distinguished holders of preferred stock from holders of debt interests, the latter possessing rights that survive a merger under Section 259 of the DGCL (or Section 18-209 of the Delaware Limited Liability Company Act in the case of a limited liability company) absent clear and unambiguous language to the contrary. Because the plaintiffs' notes did not entitle them to participate in LaneScan's governance or its profits and otherwise bore all of the hallmarks of debt instruments, the Court held that plaintiffs' rights could not be eliminated in a merger absent their consent.

According to defendants' second argument, plaintiffs had consented to the cancellation of their notes pursuant to a drag-along provision in LaneScan's limited liability company agreement. Specifically, the drag along provision required LaneScan's preferred holders to "take all necessary and desirable actions reasonably requested in connection with the consummation of [a] Company Sale." It was undisputed that the merger constituted a "Company Sale" under the drag along provision and that defendants had asked plaintiffs to sign agreements contributing their notes to the merger as holders of preferred interests. However, the parties disputed whether the language in the drag along provision could be used to force the cancellation of plaintiffs' notes in a merger. The Court agreed with the plaintiffs finding that the broad general language in the drag along provision did not meet the "clear and unambiguous" standard that contract language authorizing a forced cancellation of a contract right.