to 1 January 2013 that do not meet the criteria set out above, but that meet all of the entry criteria for Additional Tier 1 or Tier 2 capital set out in Basel III: A global regulatory framework for more resilient banks and banking systems, will be considered as an "instrument that no longer qualifies as Additional Tier 1 or Tier 2" and will be phased out from 1 January 2013 according to paragraph 94(g).

NOTE: COCOS

The nearly inscrutable language above is intended to effect a fundamental shift in bank capitalization. All non-common Tier 1 and Tier 2 capital must be either convertible to common or open to mandatory exchange for common "at the point of nonviability." Conversion or exchange must occur before injection of any public funds to prop up the bank. In the world of sovereign debt and bank capital, this is known as a "bail in" provision. "Bail in" is opposed to "bail out," and simply means that existing creditors take haircuts before the ministration of external rescue money.

The Basel document is not very clear. When is a bank "nonviable" and why the link to public financial support? Apparently both must be on the table at the moment the bank supervisor pulls the trigger and turns the bank's preferred and subordinated debt into common. Another question concerns the fit with Dodd–Frank and its constraints on emergency support to financial institutions. Whatever the technical problems, there is an overarching question concerning potential demand for CoCos in the credit markets, particularly as regards conversion in the discretion of national bank regulators.

Banks abroad already have been issuing contingent convertible securities in anticipation of the new rules. Unfortunately, not all conform to the guidelines described in the above Basel Consultation Document. Existing issues tend to specify a conversion trigger in financial terms rather than to remit the decision to a national bank regulator. See Patrikis, Basel III: Near Death Capital, 128 Banking L.J. 401 (2011).

SECTION C. VENTURE CAPITAL FINANCE

1. OVERVIEW

(A) HISTORY AND CHARACTERISTICS

Gompers and Lerner, The Use of Covenants: An Empirical Analysis of Venture Capital Partnership Agreements, 39 J.L. & Econ. 463, 465–69 (1996), describes the venture capital industry:

"Entrepreneurs often develop ideas that require substantial capital to implement. Most entrepreneurs do not have sufficient funds to finance these projects themselves and must seek outside financing. Start-up companies that lack substantial tangible assets, expect several years of negative earnings, and have uncertain prospects are unlikely to receive bank loans or other debt financing. Venture capitalists finance these high-risk, potentially high-reward projects, purchasing equity stakes while the firms are still privately held. Venture capitalists have backed many high-technology companies, including Microsoft, Intel, Lotus, Apple Computer, and Genentech, as well as a substantial number of service firms.

''Whether the firm is in a high-or low-technology industry, venture capitalists are active investors. They monitor the progress of firms, sit on boards of directors, and mete out financing based on the attainment of milestones. Venture capitalists retain the right to appoint key managers and remove members of the entrepreneurial team. In addition, venture capitalists provide entrepreneurs with access to consultants, investment bankers, and lawyers.

''The first modern venture capital firm, American Research and Development (ARD), was formed in 1946. A handful of other venture funds were established in the decade after ARD's formation. Most, like ARD, were structured as publicly traded closed-end funds. The first venture capital limited partnership, Draper, Gaither, and Anderson, was formed in 1958. Imitators soon followed, but limited partnerships accounted for a minority of the venture pool during the 1960s and 1970s. The remainder of venture capital organizations were either closed-end funds or small business investment companies (SBICs), federally guaranteed risk-capital pools that proliferated during the 1960s. The annual flow of money into new venture funds during these years never exceeded a few hundred million dollars and usually was much less.

''Funds * * * flowing into the venture capital industry and the number of active venture organizations increased dramatically during the late 1970s and early 1980s.* * *

''The single most important factor accounting for the increase in money flowing into the venture capital sector was the 1979 amendment to the 'prudent man' rule governing pension fund investments. Prior to that date, the Employee Retirement Income Security Act of 1974 prohibited pension funds from investing substantial amounts of money in venture capital or other high-risk asset classes. The Department of Labor's clarification of the rule explicitly allowed pension managers to invest in high-risk assets, including venture capital. The rule change opened the door to pensions' tremendous capital resources. * * * [I]n 1978, when $424 million was invested in new venture capital funds, individuals accounted for the largest share (32 percent). Pension funds supplied just 15 percent. Eight years later, when more than $4 billion was invested, pension funds accounted for more than half of all contributions.

''An associated change during the 1980s was the increasing role of investment advisers. During the late 1970s and early 1980s, almost all pension funds invested directly in venture funds. Because venture capital was a small portion of their portfolios, few resources were devoted to monitoring and evaluating these investments. During the mid–1980s, investment advisers (often referred to as 'gatekeepers') entered the market to advise institutional investors about venture investments. The gatekeepers pooled resources from their clients, monitored the progress of existing investments, and evaluated potential new venture funds. By 1991, one-third of all pension fund commitments were made through an investment adviser. One-fifth of all money raised by new funds came through an investment adviser.

''A final change in the venture capital industry during this period was the rise of the limited partnership as the dominant organizational form. In a venture capital limited partnership, the venture capitalists are general partners and control the fund's activities. The investors serve as limited partners. Investors monitor the fund's progress, attend annual meetings, but cannot become involved in the fund's day-to-day management if they are to retain limited liability. Venture partnerships have predetermined, finite lifetimes (usually 10 years, though extensions are often allowed). Most venture organizations raise funds every 2–5 years. * * * [P]artnerships have grown from 40 percent of the venture pool in 1980 to 81 percent in 1992.''

Venture capital commitments rose substantially in the 1990s with the amount of committed capital increasing twentyfold during the course of the decade. By 2000, the peak year, there were 228 venture capital funds with a total committed capital of $67.7 billion. The tech boom thereupon collapsed and the sector thereafter underwent severe contraction.

Why venture capital? Two theoretical models offer some insights. Ueda, Banks Versus Venture Capital: Project Evaluation, Screening, and Expropriation, 59 J. Fin. 601 (2004), compares financing by venture capital firms with financing by banks and describes a trade off. The venture capitalists are specialists and do a better job of screening good and bad projects. At the same time they position themselves to expropriate the project and use their position to extract rents. The upshot is that venture projects have less collateral but higher risk, growth, and profitability. Winton and Yerramilli, Entrepreneurial Finance: Banks Versus Venture Capital, 8 J. Fin. Econ. 51 (2008), focuses on monitoring after investment to take us to more or less the same place. Venture capitalists monitor well and extract higher returns in exchange, simultaneously imposing illiquidity on their investees. Bank financing costs less, but is ill-suited to risky projects with skewed cash flows, low probability of success, and low liquidation value but high returns on the upside. Summarizing, venture capital works with high risk, high return projects and comes with a strong arm.

Kaplan, Sensoy, and Stromberg, Should Investors Bet on the Jockey or the Horse? Evidence from the Evolution of Firms from Early Business Plans to Public Companies, 64 J. Fin. 75 (2009), amplifies this characterization with survey of venture-backed firms that went the distance and achieved IPOs. It seems that venture backs ideas rather than individuals. Managers are replaced frequently even as lines of business stay stable. Inderst and Miller, Early–Stage Financing and Firm Growth in New Industries, 93 J. Fin. Econ. 276 (2009), adds a point: Venture capital is attracted to competitive industries and industries with network effects and economies of scope. The idea is to select a well-positioned company and make a big infusion of capital in a play for long-run domination.

(B) SECURITIES AND DOCUMENTATION

National Venture Capital Association Term Sheet

Appendix A, Form 9

Although there is no one-size-fits-all term sheet for venture capital transactions, one can expect them to involve the private placement of equity securities (or debt securities convertible into equity securities). Convertible preferred stock usually is the security issued. In some deals, this states a fixed dividend preference, often noncumulative; other deals employ participating preferred incorporating a fixed dividend preference and pro rata participation with the common above the preference amount.

An issue of venture capital convertible preferred is likely to be sold pursuant to a Stock Purchase Agreement and an Investors' Rights Agreement entered into between the company, usually referred to as the ''entrepreneur'' in this context, and the venture capital investors. The Stock Purchase Agreement sets the terms and conditions of the private placement. The Investors' Rights Agreement sets out registration rights respecting the purchased securities and rights of first refusal respecting subsequent issues of securities. This Agreement also sets out governance rights for the venture capitalist, including rights to information and the right to inspect the issuer's premises, and also may include strict business covenants. The dividend, liquidation, redemption, and voting rights of the preferred stock will, of course, be placed in the issuer's charter.

These contracts' primary job is to align the incentives of both the entrepreneur and the venture capitalist toward success and, in the event of success, to provide for gain sharing and access to liquidity for the venture capitalist. The expectation is that if the project is successful, the venture capitalist realizes its investment yield by cashing out by participating in an initial public offering. Thereafter the entrepreneur is left in control of the firm. The contract protects the venture capitalist's upside interest in the terms of the conversion privilege attached to the preferred and the provision of registration rights facilitating later exit via the public trading markets. The contract also likely will provide for mandatory conversion of venture capital preferred in the event of a qualifying IPO. ''Qualification'' means that the IPO passes quality tests keyed to the stock price, the amount of proceeds, or the resulting market capitalization. This assures that the venture capitalist does indeed exit and leave the entrepreneur in unchallenged control.

An IPO is not the only available means of upside exit for the venture capitalist. Sale of the going concern to a third-party firm also is an option. In this case the venture capital preferred remains unconverted and the board of the start up negotiates with the board over the purchaser over the terms of a merger. The National Venture Capital Association reports that from 1996 to 2004 there were more exits by sale than by IPO in 7 of 9 years. See Hellman, IPOs, Acquisitions, and the Use of Convertible Securities in Venture Capital, 81 J. Fin. Econ. 649 (2006).

Concerns about the entrepreneur's incentives also loom large on the upside. These are addressed by allocating the entrepreneur's equity interest in the firm's growth in the form of options to take common stock that vest over time. Sequential option vesting diminishes any temptation to abandon the project prior to the IPO phase. In those cases where the entrepreneur does not have boardroom control, the contingent payoff arrangement also imports a high-powered incentive to remain in the good graces of the venture capitalist and any outside directors.

Venture capital contracts treat downside scenarios by shaping priorities. A start up firm creating no value and running out of capital goes into bankruptcy, probably to be liquidated once there. Alternatively, if the start up has no significant debt, a liquidation is conducted privately. Either way, the risk of complete failure is intrinsic to venture capital investment. Venture capital firms moderate it by staging the entrepreneur's draw downs of capital, by diversifying their portfolios of investments in startup firms, by syndicating investments in particular firms, and by closely monitoring their positions. When a particular investment does turn out to be a complete failure, the contract structures priorities to allocate any crumbs left on the table to the venture capitalist. But these will not amount to much.

Poor or mediocre performance short of complete failure presents a less tractable problem, one resembling that of preferred stock issued by underperforming mature issuers. Poor results can mean that venture capital is cut off, given staged investment. Venture capital preferred tends to take an intermediate term, with a duration of four to six years. When the time is up, redemption rights become exercisable. The mediocre performer still limping along either finds replacement capital, is sold to a third party, or is liquidated. (Alternatively, it defends itself in court, as we saw with ThoughtWorks, supra Part III, section A.) In any case, the interests of the entrepreneur and the venture capitalist can come into sharp conflict, with the former desiring continuation and a chance for an upside recovery and the latter desiring termination and the present realization of any value on the table.

Poor performance is not unusual. One-third of venture capital issuers end up insolvent. Another third limp along, generating enough cash to pay expenses, especially the insiders' salaries, but never generating enough profit to support a public offering of common stock. Another third succeeds, reaching the initial public offering stage and generating substantial returns for venture capital investors—enough to compensate them for the high risk and illiquidity of their overall venture capital portfolios. Dent, Venture Capital and the Future of Corporate Finance, 70 Wash. U.L.Q. 1029, 1034 (1992).

(C) CONTROL ARRANGEMENTS

National Venture Capital Association Voting Agreement

Appendix A, Form 10, section 1

Sometimes the entrepreneur so needs venture capital that it cedes both a majority of stock and control of the boardroom to the venture capitalist.

If the portfolio company succeeds, control returns to the entrepreneur when the venture capitalist sells its stock in an initial public offering (IPO). Black and Gilson, Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets, 47 J. Fin.Econ. 243, 253, 255–56, 260–61 (1998), discusses the resulting contracting problems. The primary problem for solution is the entrepreneur's lack of assurance against opportunistic retention of control by venture capitalist through undue delay of the IPO. They suggest that an "implicit contract" backed by reputational constraints and financial incentives assures the entrepreneur that the venture capitalist will voluntarily surrender the reins. See also Hellman, The Allocation of Control Rights in Venture Capital Contracts, 29 Rand J. Econ. 57 (1998).

How often does the venture capitalist get complete control? Kaplan and Stromberg, Financial Contracting Theory Meets the Real World: An Empirical Study of Venture Capital Contracts, 70 Rev. Econ. Stud. 281 (2003), gathers contracting data from venture capital investments in 118 start ups made by 14 venture capital firms. Kaplan and Stromberg find that one party, venture capitalist or entrepreneur, controls the board in only 38 percent of their cases. In this subset, the venture capitalist takes control in two thirds of the cases and the entrepreneur takes control in one third of the cases. In the remaining 62 percent of the cases, they report that neither side takes control. Instead, each party designates a director for a seat or seats. They then are to agree on a candidate to fill the remaining seat or seats. The third party director takes the arbitrator's role in the event of disputes. Boardroom control accordingly is shared.

Kaplan and Stromberg also have data on voting control. Venture capital transactions tend to provide separate voting schemes for board election and for other matters on which shareholders vote, with the latter proceeding on a one vote per share basis. Voting control over matters like charter amendments and mergers thus goes to the actor, entrepreneur or venture capitalist, holding the largest number of shares. Here are Kaplan and Stromberg's figures respecting the allocation of these votes for all rounds of financing: In 70.8 percent of the cases, the venture capitalist controls a majority of the votes, assuming no performance-based stock allocations to the entrepreneur ever come to vest. Given full vesting, the number of cases in which venture capitalist controls a majority decreases to 55.8 percent. Entrepreneur controls in 11.6 percent of the cases, rising to 23.1 percent given full vesting. Neither party controls in 17.6 percent, rising to 21.1 given full vesting.

Smith, The Exit Structure of Venture Capital, 53 UCLA L. Rev. 315 (2005), reviews the documents governing 367 startups that made SEC filings in connection with IPOs. He finds that the charter vests sole control in one party in 38 percent of the cases, with the venture capitalist receiving control in 77 percent of the sole control subset. These results more or less track those of Kaplan and Stromberg. But, as to the other cases, Smith produces a contrasting picture of the practice. According to Smith, entrepreneurs tend to start out in control of the board of directors, with venture capitalists taking voting control as they contribute more and more capital through staged draw downs during the start up process. He also finds no evidence of shared control arrangements, even though the documents do tend to expressly allocate one set of board seats to the venture capitalist, a second set of board seats to the entrepreneur, and leave open the allocation of a third seat or set of seats occupying a tie breaking position. According to Smith, the documents provide for voting by all shareholders voting as a single class on the open seat or seats. Given a conflict, it follows that control in the end goes to party possessing the voting majority.

Equity–Linked Investors, L.P. v. Adams

Court of Chancery of Delaware, 1997.
705 A.2d 1040.

■ ALLEN, CHANCELLOR.

The case now under consideration involves a conflict between the financial interests of the holders of a convertible preferred stock with a liquidation preference, and the interests of the common stock. The conflict arises because the company, Genta Incorporated, is on the lip of insolvency and in liquidation it would probably be worth substantially less than the $30 million liquidation preference of the preferred stock. Thus, if the liquidation preference of the preferred were treated as a liability of Genta, the firm would certainly be insolvent now. Yet Genta, a bio-pharmaceutical company that has never made a profit, does have several promising technologies in research and there is some ground to think that the value of products that might be developed from those technologies could be very great. Were that to occur, naturally, a large part of the ‘‘upside’’ gain would accrue to the benefit of the common stock, in equity the residual owners of the firm's net cash flows. (Of course, whatever the source of funds that would enable a nearly insolvent company to achieve that result would also negotiate for a share of those future gains—which is what this case is about). * * *

* * *

* * * Plaintiff is Equity–Linked Investors, L.P. (together with its affiliate herein referred to as Equity–Linked), one of the institutional investors that holds Genta's Series A preferred stock. Equity–Linked also holds a relatively small amount of Genta's common stock, which it received as a dividend on its preferred. The suit challenges the transaction in which Genta borrowed on a secured basis some $3,000,000 and received other significant consideration from Paramount Capital Asset Management, Inc., a manager of the Aries Fund (together referred to as ‘‘Aries’’) in exchange for a note, warrants exercisable into half of Genta's outstanding stock, and other consideration. The suit seeks an injunction or other equitable relief against this transaction.

* * * [F]rom a realistic or finance perspective, the heart of the matter is the conflict between the interests of the institutional investors that own the preferred stock and the economic interests of the common stock * * *. * * * [T]he facts out of which this dispute arises indisputably entail the

restructuring transactions used as a basis for comparison. He appraised the merits of the plaintiffs' claim as follows:

"In allocating the consideration of this merger, the directors, although they were elected by the common stock, owed fiduciary duties to both the preferred and common stockholders, and were obligated to treat the preferred fairly. See Eisenberg v. Chicago Milwaukee Corp., Del.Ch., 537 A.2d 1051, 1062 (1987); Jedwab v. MGM Grand Hotels, Del.Ch., 509 A.2d 584, 593–94 (1986). That standard is, of course, a somewhat opaque one that, unless procedures are employed that are sufficient in themselves to give reasonable assurance of fairness, may require a reviewing agency to make a highly specific inquiry of the company and the transaction.

"In preliminarily assessing plaintiffs' claim, I note first that here no mechanism employing a truly independent agency on the behalf of the preferred was employed before the transaction was formulated. Only the relatively weak procedural protection of an investment banker's *ex post* opinion, was available to support the position that the final allocation was fair. * * *

* * *

"If this case proceeds to an adjudication of the merits of plaintiffs' claims, defendants will bear the burden of proving that the allocation was fair to the preferred. * * * "

LC Capital Master Fund, Ltd. v. James

Court of Chancery of Delaware, 2010.
990 A.2d 435.

■ STRINE, VICE CHANCELLOR.

I. *Introduction*

Plaintiff LC Capital Master Fund, Ltd. ("LC Capital"), a preferred stockholder of QuadraMed Corporation ("QuadraMed"), seeks to enjoin the acquisition by defendant Francisco Partners II, L.P. ("Francisco Partners") of QuadraMed (the "Merger") because the consideration to be received by the preferred stockholders of QuadraMed does not exceed the "as if converted" value the preferred were contractually entitled to demand in the event of a merger. That "as if converted" value was based on a formula in the certificate of designation (the "Certificate") governing the preferred stock, and gave the preferred the bottom line right to convert into common at a specified ratio (the "Conversion Formula") and then receive the same consideration as the common in the Merger. The plaintiff purports to have the support of 95% of the preferred stockholders in seeking injunctive relief and I therefore refer to the plaintiff as the preferred stockholders.

* * *

* * * I find that the preferred stockholders have not proven a reasonable probability of success on the merits of their fiduciary duty claim. * * *

* * * [The preferred stockholders should] * * * seek relief through appraisal or through an equitable action for damages. * * *

II. *Factual Background*

* * *

Under the terms of the challenged merger agreement (the ''Merger Agreement''), Francisco Partners will acquire QuadraMed at a price of $8.50 per share of common stock. The preferred stockholders will receive $13.7097 in cash in exchange for each share of preferred stock. The price for the preferred stock set forth in the Merger Agreement was pegged to the conversion right the Certificate granted to the preferred stockholders in the event of a merger. That conversion right allowed the preferred stockholders to convert their preferred shares into common shares and then to receive the same consideration as the common stock received in the merger. The conversion was determined by using the Conversion Formula of 1.6129 shares of preferred stock to one share of common stock. That is, in order to value the preferred stock, the merging parties agreed to simply cash out the preferred stock at the price the preferred.

The preferred stockholders seek to enjoin the Merger on the grounds that the defendants breached their fiduciary duties of care and loyalty. But, the preferred stockholders do not allege that the defendants breached their *Revlon* duties as to *all* shareholders by approving a transaction that does not fully value QuadraMed as an entity. Instead, the preferred stockholders argue that the Merger consideration was unfairly allocated between the common and preferred stock. That is, the preferred stockholders do not challenge the overall adequacy of the Merger consideration. Rather, the preferred stockholders claim that they simply did not receive a big enough slice of the pie because the Board allocated the Merger consideration to the preferred stock on an ''as-if converted'' basis, which the preferred stockholders believe understates the value of their shares.

1. *The Rights Of The Preferred Stockholders*

Requesting a preliminary injunction is the only means the preferred stockholders have to block the transaction because, per the Certificate, the preferred stock does not have the right to vote on a merger. The circumstances in which the preferred stock has voting rights are limited to: (1) if the Certificate were to be amended in a way ''that materially adversely affects the voting powers, rights or preferences'' of the preferred stockholders; (2) if any class of shares with ranking before or in parity with the preferred stock were to be created; and (3) if the company were to incur ''any long term, senior indebtedness of the Corporation in an aggregate principal amount exceeding $8,000,000.'' Relatedly, if four quarterly dividends are in arrears, the preferred stockholders can elect two substitute directors.

The Certificate includes a number of other rights for the preferred stock that are arguably relevant to the current dispute. As mentioned, the preferred stock has a dividend right. This provides for the payment of a dividend of $1.375 per year, but it is to be paid only ''when, as and if authorized and declared'' by the Board. The Certificate also provides a liquidation preference of $25 (plus accrued dividends) for each share of preferred stock. But, the Certificate does not afford the preferred stock a right to force a liquidation. Most relevantly, the Certificate expressly provides that a merger does not trigger the preferred stock's liquidation preference.

The preferred stockholders also point out that the Certificate includes a mandatory conversion right that allows QuadraMed to force the preferred stockholders to convert into common shares. The preferred stockholders stress that this provision of the Certificate may only be used by QuadraMed to force conversion when the company's common stock hits a price of $25 per share, far above the $8.50 per common share Merger value. But, like the liquidation preference, the mandatory conversion provision does not have bite in a merger. That is, the Certificate does not provide that, in the event of a merger, the preferred stockholders must be converted at a formula that affords the preferred stockholders an implied common stock value of $25 per share.

To the contrary, in a merger, the preferred stockholders will receive either: 1) the consideration determined by the Board in a merger agreement; or 2) if the preferred choose, the right to convert their shares using the Conversion Formula into common shares and redeem the same consideration as the common stockholders. The bottom line right of the preferred stockholders in a merger, therefore, is not tied to its healthy liquidation preference or the company's mandatory conversion strike price-it is simply the right to convert the shares into common stock at the Conversion Formula and then be treated pari passu with the common.

2. *The Board's Decision To Accept Francisco Partners' Bid For QuadraMed*

Over the years, QuadraMed received expressions of interest from a number of potential acquirors. From 2008 to date, QuadraMed has been seriously considering a sale. From early on in this strategic process, the preferred stockholders demanded a high price, even $25, for their stock, apparently under the mistaken view that they had a right to their liquidation preference in the event of a merger. Initially, some bidders indicated an interest in either meeting the preferred stockholders' asking price-which would mean paying much more for the preferred stock than the common-or at least allowing the preferred stock to remain outstanding after the consummation of a merger. For example, Francisco Partner's first bid for QuadraMed, made in October 2008, offered to acquire the company at $11 per share of common stock and to allow the preferred stock to remain outstanding. And, a later bid, received August 31, 2009 from a bidder referred to as ''Bidder D'' in the proxy materials, proposed acquiring QuadraMed for $10.00 per share of common stock, and $25.00 par value for each share of preferred stock. By ''par value,'' Bidder D seems not to have meant to offer the preferred stockholders $25 per share in current value but a security with the future potential of reaching that value. But this was perhaps not as clearly expressed as it could have been.

As the negotiations continued, moreover, both Francisco Partners and Bidder D revised their offers downward. After several months of negotiating, Francisco Partners submitted a revised offer of $9.50 per share of common stock, with the requirement that the preferred stock be cashed-out. In March 2009, the Board rejected this offer, and negotiations with Francisco Partners were suspended. And, after its initial approach, Bidder D made very plain its earlier position and explained that it "never intended to offer face value" for the preferred stock and was instead interested in paying $10 per share of common stock and reaching agreement with the holders of preferred stock on the terms of a debt instrument with a $25 face value, but a present value equal to $10 per share on an as-if converted basis. Therefore, the treatment of the preferred stock and common stock under Bidder D's initial proposal and under the Merger is not as different as at first appears.

In light of the various bids being made for the company, QuadraMed's outside counsel, Crowell & Moring, LLP ("Crowell & Moring"), sent the QuadraMed Board a memorandum on September 1, 2009 addressing the legal issues relating to apportioning merger consideration between the common stock and preferred stock (the "September 2009 Memorandum"). In substance, the September 2009 Memorandum was Crowell & Moring's distillation of and update to a memorandum that Richards, Layton & Finger, P.A. ("Richards Layton"), QuadraMed's Delaware counsel, had prepared in June 2006. In 2006, while QuadraMed was in negotiations over a possible acquisition by a private equity firm, referred to as "Bidder B" in QuadraMed's proxy materials, Richards Layton authored a memorandum, dated June 22, 2006, that provided a general overview of the legal authority relevant to allocating merger consideration between common stock and preferred stock in a merger. The memorandum was addressed to counsel, Crowell & Moring, not the QuadraMed Board. Crowell & Moring's September 2009 Memorandum summarized Richards Layton's 2006 advice and discussed this court's April 2009 decision In re Appraisal of Metromedia Int'l Group, Inc., [971 A.2d 893 (Del.Ch.2009)] which addressed the allocation of merger consideration between common and preferred stock in the context of an appraisal action.

The QuadraMed Board formed a special committee of independent directors (the "Special Committee") to evaluate the various bids. QuadraMed's Board is comprised of six individuals: Duncan James, William Jurika, Lawrence English, James Peebles, Robert Miller, and Robert Pevenstein (collectively, the "Special Committee members"). The Special Committee was comprised of Jurika, English, Peebles, Miller, and Pevenstein-that is, all of the Special Committee members except James, who was also QuadraMed's Chief Executive Officer. With the exception of Jurika, who owns over 650,000 shares of QuadraMed common stock, the Special Committee members hold a nominal amount of QuadraMed shares and in the money stock options. The preferred stockholders have not presented any evidence that these members' holdings of QuadraMed shares and options constitute a material portion of their personal wealth.

In early autumn 2009, after Bidder D's approach in August, QuadraMed's investment bankers shopped the deal. At this time, Francisco Partners made a second bid, offering $8.50 per share of common stock and requiring the cash-out of the preferred stock on an as-if converted basis, which yielded a value of $13.7097 per preferred share. Francisco Partners insisted on cashing out the preferred stock because it did not want to bear the risk of a voluntary conversion of the preferred stock into common stock after the Merger. The evidence also indicates that Francisco Partners wanted to increase QuadraMed's borrowing after the Merger, and therefore wanted to eliminate the preferred stock because the Certificate gives the preferred stock a right to vote on any incurrence of debt in excess of $8,000,000.

Because the preferred stockholders were demanding more consideration than the common stock, one of the questions before the Special Committee was what fiduciary duties it owed to the common stock and preferred stock when allocating the proposed Merger's consideration. The evidence indicates that the Special Committee carefully considered the duties it owed to both the preferred and common stockholders, and was concerned about any perception that it was favoring one class over the other. In a series of meetings, the Special Committee reviewed the bids, and at those meetings, QuadraMed's counsel informed the Special Committee that the Board could adopt a merger agreement that cashed out the preferred stockholders, and that, if the Board respected the bottom line contractual rights of the preferred stockholders in a merger, it did not have to allocate additional value to the preferred stockholders. Indeed, Crowell & Moring said that the Board had to be careful about giving the preferred stockholders more unless there were special reasons to do so. Crowell & Moring also reported that Francisco Partner's counsel, Shearman & Sterling, LLP, had also reached the conclusion that a cash out of the preferred stock at closing was permissible under Delaware law, and that Francisco Partners would not insist on an ''appraisal out'' provision in the Merger Agreement so as to satisfy any concerns the Special Committee might have regarding the treatment of the preferred stock.

Meanwhile, Bidder D had been attempting to persuade the preferred stockholders to take a new debt security with a current value equal to what the common would receive but with a future upside. But, Bidder D found it ''extremely difficult'' to convince the holders of preferred stock to exchange their stock for a new debt security, and its bid foundered. Once Bidder D withdrew its offer on November 22, 2009, Francisco Partners became the only remaining bidder for QuadraMed. Although the Special Committee resisted cashing out the preferred stock for some time, the Committee eventually relented once it became clear that Francisco Partners would not do a deal that allowed QuadraMed's preferred stock to survive the Merger.

On December 7, 2009, a Special Committee meeting was held to consider approval of the Merger with Francisco Partners. At that meeting, Piper Jaffray, QuadraMed's financial advisor, presented an opinion that $8.50 per common share was fair to the common stockholders from a financial point of view. There was no separate opinion addressing the fairness of the Merger to the preferred stockholders. After deliberation, the Special Committee unanimously approved the Merger with Francisco Partners. From the meeting minutes, it appears that the Special Committee was wary of doing a deal that allocated more consideration to the preferred stock than to the common stock for two reasons: (1) shifting additional merger consideration to the preferred stock would cause the holders of common stock, who were the only stockholders who had a right to vote on the Merger, to vote against the transaction; and (2) there was no special reason to deviate from the Conversion Formula provided in the Certificate for allocating consideration to the preferred stock.

In the latter regard, it is fair to say that the Special Committee's equitable heartstrings were not moved to bestow upon the preferred stockholders anything better than receipt of the same treatment as the common stockholders on an as-if converted basis. Had a particular bidder insisted, after negotiations with the preferred, on doing a deal with differential consideration, the Special Committee would seem to have had an open and receptive mind if the proposal offered a more favorable valuation to all stockholders. But even then, the Special Committee, I infer, would have harbored a concern if the allocation system strayed too far (in either direction) from the Conversion Formula in the Certificate.

III. *Legal Analysis*

* * *

B. *The Preferred Stockholders Have Not Met Their Burden To Justify Enjoining The Merger*

1. *The Preferred Stockholders Have Not Shown That The QuadraMed Board Likely Breached Its Fiduciary Duties By Allocating To The Preferred Stock The Bottom Line Consideration Contractually Owed To Them*

* * * The preferred stockholders, pointing to the decisions of this court in *Jedwab v. MGM Grand Hotels, Inc*. [509 A.2d 584 (Del.Ch.1986),] and *In re FLS Holdings, Inc. Shareholders Litigation*, [1993 WL 104562 (Del.Ch. Apr. 2, 1993),] argue that the QuadraMed board had the duty to make a "fair" allocation of the Merger consideration between the common and preferred stockholders. To do this fairly, the preferred stockholders argue that the board had to set up some form of negotiating agent, with the duty and discretion to exert leverage on behalf of the preferred stockholders in the allocation process. This need, the preferred stockholders say, is heightened because of an unsurprising fact: the directors of QuadraMed own common stock and do not own preferred stock. Indeed, the preferred stockholders say, every member of the Special Committee owned common stock and one member, Jurika, owned over five million dollars worth. How, they say, could such directors fairly balance the interests of the preferred against their own interest in having the common get as much as possible? At the very least, the preferred imply, the QuadraMed Board should have charged certain directors with representing the preferred, and enabled them to retain qualified legal and financial advisors to argue for the preferred and to value the preferred based on its unique contractual rights and their economic value.

* * *

* * * I perceive no basis to find that the directors sought to advantage the common stockholders at the unfair expense of the preferred stockholders. What the preferred stockholders complain about is that the directors did not perceive themselves as having a duty to allocate more Merger consideration to the preferred than the preferred could demand as an entitlement under the Certificate. Had the Board been advised properly and had the right mindset, the preferred stockholders say, they would have given weight to various contractual rights of the preferred, such as their liquidation preference rights, and determined that on the basis of those rights, they should get a higher share than the Certificate guaranteed they could demand. Ideally, in fact, the Board should have employed a bargaining agent on their behalf to vigorously contend for the proposition that the largest part of the roast should be put on the preferred stockholders' plate.

* * *

A close look at those cases, however, does not buttress the preferred stockholders' arguments. Notable in both cases was the absence of any contractual provision such as the one that exists in this case. That is, from what one can tell from *FLS Holdings* and *Jedwab,* there was no objective contractual basis-such as the conversion mechanism here-in either of those cases for the board to allocate the merger consideration between the preferred and the common. In the absence of such a basis, the only protection for the preferred is if the directors, as the backstop fiduciaries managing the corporation that sold them their shares, figure out a fair way to fill the gap left by incomplete contracting. Otherwise, the preferred would be subject to entirely arbitrary treatment in the context of a merger.

The broad language in *FLS Holdings* and *Jedwab* must, I think, be read against that factual backdrop. I say so for an important reason. Without this factual context, those opinions are otherwise in sharp tension with the great weight of our law's precedent in this area. In his recent decision in [*In re Trados Inc. Shareholder Litigation*, 2009 WL 2225958, at *7 (Del.Ch. 2009)], Chancellor Chandler summarized the weight of authority very well:

> Generally the rights and preferences of preferred stock are contractual in nature. This Court has held that directors owe fiduciary duties to preferred stockholders as well as common stockholders where the right claimed by the preferred "is not to a preference as against the common stock but rather a right shared equally with the common." Where this is not the case, however, "generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of the common stock-as the good faith judgment of the board sees them to be-to the interests created by the special rights, preferences, etc., of preferred stock, where there is a conflict." Thus, in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders.

Notably, that summary relied heavily on decisions by Chancellor Allen, who authored both *Jedwab* and [*Equity–Linked Investors, L.P. v. Adams*, 705

A.2d 1040, 1042 (Del.Ch.1997)]. Does the summary of *Trados* expose some inconsistency in our law?

No, not when Chancellor Allen's decision in *HB Korenvaes Investments, L.P. v. Marriott Corp.* [1993 WL 205040 (Del.Ch. June 9, 1993),] is considered. In that case, a board took very aggressive action that was, objectively speaking, adverse to the interest of the preferred stockholders. The Marriott board agreed to a transaction that issued a large special dividend (of certain businesses!) to the common stock and indefinitely suspended dividends on the preferred stock. The preferred stockholders then sought to enjoin the payment of the special dividend, arguing that Marriott's directors breached their fiduciary duties to the preferred stockholders by agreeing to the transaction. Chancellor Allen rejected that argument, finding that even on the assumption that the board had acted to advantage the common in the transaction, no breach of duty of loyalty claim was stated.

* * * Chancellor Allen * * * found that the fact that the certificate of designation considered the possibility of an in-kind dividend and gave the preferred certain rights in that context was dispositive of whether there was any fiduciary duty claim * * *.

The reasoning of *Korenvaes* reconciles the doctrine. When, by contract, the rights of the preferred in a particular transactional context are articulated, it is those rights that the board must honor. To the extent that the board does so, it need not go further and extend some unspecified fiduciary beneficence on the preferred at the expense of the common. When, however, as in *Jedwab* and *FLS Holdings,* there is no objective contractual basis for treatment of the preferred, then the board must act as a gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred.

This case is much closer to *Korenvaes* than it is to *Jedwab.* Although the preferred stockholders make much of the fact that the Certificate does not mandate that the Board accord the preferred stockholders the same treatment as the common in a merger, the only right that the preferred stockholders extracted for themselves was to receive the same consideration they would have received if they had converted their shares per the Conversion Formula set forth in the Certificate. In a situation where the preferred have no mandatory right to annual dividends, no voting rights on a merger, and where the Certificate plainly provides that a merger is not a liquidation event triggering a right to receipt of accrued dividends and the liquidation preferences before the common is paid, it is difficult to fathom any duty on the part of the QuadraMed Board to go further and allocate additional value to the preferred. * * *

This, of course, is not to say that the QuadraMed Board did not owe the preferred stockholders fiduciary duties in connection with the Merger. The Board certainly did. But those were the duties it also owed to the common. In the context of a sale of a company, those are the duties articulated in *Revlon* and its progeny; namely, to take reasonable efforts to secure the highest price reasonably available for the corporation. Notably, the preferred stockholders do not argue that the Board fell short of its obligations in this regard.[56] They simply want more of the proceeds than

56.

Therefore, in this decision, I need not confront what might be considered a much harder case. Imagine an issuance of preferred stock that had an absolute right to annual dividend payments of a large amount. The corporation's discounted cash flow (''DCF'') valuation indicates that the corporation could pay those dividends. The certificate of designation, like the one here, only gives the preferred the right to convert based on a formula, and does not give the preferred the right to vote on a merger, nor does it treat a merger as an event implicating the preferred's right to a liquidation preference.

The corporation is valued fairly based on a DCF model in the merger. That is, the total consideration is fair. But, the conversion formula results in the preferred stockholders receiving a price for their shares that is lower than the discounted value of the dividends the preferred stockholders would be guaranteed to receive in the next five years. The board realizes this but chooses not to allocate more consideration to the preferred. This hypothetical case is harder because the financial analysis undergirding the board's determination to proceed with the merger suggests that the corporation would have the financial capacity to pay the dividends to the preferred and that the certificate of designations would require that the board do so if the corporation remained as a going concern.

But remember that the preferred would not have bargained for, in the context of a merger, any contractual protection other than the bottom line right to be treated on as converted basis and the board would not have dishonored that protection. Under the reasoning of Chancellor Allen in *Korenvaes,* the board would not have owed any fiduciary duty of loyalty to somehow adjust upward the preferred stock's portion of the consideration. In that case, as mentioned, he sanctioned aggressive board action that clearly advantaged the common at the expense of the preferred. Because the preferred had bargained only for a limited right of protection in that context and the board has not deprived them of that protection, Chancellor Allen found that the board had no further duty and could take the action it did.

I need not answer the hard case here because the preferred stockholders have made no argument along these lines and have no right to demand that they actually receive annual dividends. The judicial sanctioning of the notion that the preferred get more merger consideration than they actually bargained for would, though, seem only to have appeal to those who believe that appraisal proceedings are now too predictable and non-burdensome. Indeed, the only thing rendering the future dividend stream in the hard case a non-speculative future source of income would be the judicial holding that preferred stockholders, who did not bargain for the right to block a merger that would result in the end of the corporation and therefore their future dividend stream, have to be compensated for the very stream that they did not procure a contractual right to force to continue. In that regard, the traditional appraisal use of the term ''going concern'' value cannot be rationally thought to have been intended to express the implicit notion that preferred stock, with no contractual right to block a merger or to receive any special economic treatment in a merger, can claim that the merger did not accord them fair value on the game theory-type speculation that: 1) if the corporation did not engage in a merger, the preferred stockholders would have received a guaranteed share of the company's going concern cash flow; 2) that although the preferred stockholders received the bottom line consideration they were guaranteed by the certificate of designation and although the total price paid for the corporation was fair, the preferred stockholders' share of the merger consideration was less than fair in light of the *contractual* share of dividends they would have received even though they did not have the *contractual* right to block the merger that terminated that stream of future payments.

This example illustrates a tension that permeates the preferred stockholders' argument. Although they rely on the Board's supposed failure to comply with the equitable duties owed to them as preferred stockholders, the preferred stockholders continually refer back to their contractual rights as the basis for arguing for special fiduciary consideration. But in the context of a merger, they had no right to demand a special they are guaranteed by the Certificate. But I do not believe that the Board acted wrongly in viewing itself as under no obligation to satisfy that desire.

To indulge such a notion would create great uncertainty and inefficiency for corporations seeking to engage in mergers and acquisitions. Having had the chance to extract more and having only obtained the right to demand treatment under the Conversion Formula that operates to allocate any consideration in a merger between the preferred and the common on a basis the preferred assented to in the Certificate, why should the preferred have the right to ask the Board to give them more? The preferred stockholders' view of what the Board should do if this notion is embraced exemplifies the problem. The preferred stockholders would have the Board consider as relevant to value facts such as the preferred stock's dividend rights, rights in the event of liquidation, and limited voting rights. These, the preferred shareholders say, should be taken into account. But, of course, if that is so, it is also necessary to take into account the fact that the common get to vote on a merger and the preferred do not, and that the common stockholders get to elect a majority of the Board even if dividends are not paid to the preferred stockholders, and the preferred get to elect two substitute directors. That is, the Board would have to "weigh" these soft contractual possibilities against each other and somehow value them. Realizing that this is not so easy, the preferred stockholders say they have a simple answer: just form two special committees, have each retain their own advisors, and go at it. They can cut up the pie, and, while they do it, the acquiror will, in their hypothetical world, wait patiently for the results.

* * *

Another counterproductive consequence would result from accepting the preferred stockholders' arguments. For its entire history, our corporate law has tried to insulate the good faith decisions of disinterested corporate directors from judicial second-guessing for well-known policy reasons. The business judgment rule embodies that policy judgment. When mergers and acquisitions activity became a more salient and constant feature of corporate life, our law did not cast aside the values of the business judgment rule. * * *

To hold that independent directors are disabled from the protections of the business judgment rule when addressing a merger because they own common stock, and not the corporation's preferred stock, is not, therefore, something that should be done lightly. Corporate law must work in practice to serve the best interests of society and investors in creating wealth. Director compensation is already a difficult enough issue to address without adding on the need to ponder whether the independent directors need to buy or receive as compensation a share of any preferred stock issuance made by the corporation, for fear that, if they do not have an equally-

dividend, consideration equal to the liquidation preference formula, or any of the other sorts of things on which they base their argument for higher value. It is only to the extent that a judge implies that rights of this kind, which could have been but were not insulated by contractual protections from defeasement by merger, must be compensated for by equity that they have economic value in a merger. Our law has not, to date, embraced the notion that Chancery should create economic value for preferred stockholders that they failed to secure at the negotiating table.

weighted portfolio of some kind, they will not be able to impartially balance questions that potentially affect the common and preferred stockholders in different ways. Adhering to the rule of Equity–Linked Investors, *Trados,* and other similar cases, which hold that it is the duty of directors to pursue the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred, avoids this policy dilemma. Admittedly, it does not solve for certain situations that directors might create themselves by authorizing multiple and sometimes exotic classes of common stock, situations that have led this court to, as a matter of necessity, consider the directors' portfolio balance, but it at least does not exacerbate the already complex challenge of compensating independent directors in a sensible way. And, given the unique nature of preferred stock and the often-fraught circumstances that lead to its issuance, our law should be chary to somehow suggest that otherwise independent directors should be receiving shares of this kind at the risk of facing being called "non-independent" or, worse, being deemed by loose reasoning to be "interested" and therefore somehow personally liable under the entire fairness standard for a merger allocation decision.

Here, the plaintiffs have also failed to impugn the Board's entitlement to the business judgment rule for a more mundane reason. Even if the court must, as I think it does not in this situation, consider whether the otherwise independent directors comprising the Special Committee could, because of their ownership of common stock and no preferred stock, impartially balance the interests at stake, the plaintiffs have not advanced facts that support a reasonable inference that any of the Special Committee members are materially self-interested. I say *any* forthrightly. As to director Jurika, who owns a large common stock stake, a shift in the merger consideration of 10% to the preferred would cost him approximately $500,000. That amount of money, of course, would be material to most Americans. But most Americans are not corporate directors, and do not have a $5.6 million stake of common stock in any company. And, the plaintiffs have not advanced any reason to believe that the hypothetical 10% shift would be important to Jurika. The man could be as rich as Croesus or Jimmy Buffett. The plaintiffs have a burden here and they have not even tried to meet it. As to the other directors on the Special Committee, they have failed even more obviously. Directors English, Miller, Peebles, and Pevenstein own only $61,284 worth of common stock and in the money options collectively. Even a fairly drastic shift of 20% of the merger consideration from the preferred to the common would only reduce those directors' collective take by approximately $28,000, and the plaintiffs do not make any attempt to show that this would be material to these directors' personal economic circumstances. Thus, even under the plaintiffs' theory, the business judgment rule, and not the entire fairness standard, applies to the Special Committee's decision.

through staged draw downs during the start up process. He also finds no evidence of shared control arrangements, even though the documents do tend to expressly allocate one set of board seats to the venture capitalist, a second set of board seats to the entrepreneur, and leave open the allocation of a third seat or set of seats occupying a tie breaking position. According to Smith, the documents provide for voting by all shareholders voting as a single class on the open seat or seats. Given a conflict, it follows that control in the end goes to party possessing the voting majority.

Equity–Linked Investors, L.P. v. Adams

Court of Chancery of Delaware, 1997.
705 A.2d 1040.

■ ALLEN, CHANCELLOR.

The case now under consideration involves a conflict between the financial interests of the holders of a convertible preferred stock with a liquidation preference, and the interests of the common stock. The conflict arises because the company, Genta Incorporated, is on the lip of insolvency and in liquidation it would probably be worth substantially less than the $30 million liquidation preference of the preferred stock. Thus, if the liquidation preference of the preferred were treated as a liability of Genta, the firm would certainly be insolvent now. Yet Genta, a bio-pharmaceutical company that has never made a profit, does have several promising technologies in research and there is some ground to think that the value of products that might be developed from those technologies could be very great. Were that to occur, naturally, a large part of the ''upside'' gain would accrue to the benefit of the common stock, in equity the residual owners of the firm's net cash flows. (Of course, whatever the source of funds that would enable a nearly insolvent company to achieve that result would also negotiate for a share of those future gains—which is what this case is about). * * *

* * *

* * * Plaintiff is Equity–Linked Investors, L.P. (together with its affiliate herein referred to as Equity–Linked), one of the institutional investors that holds Genta's Series A preferred stock. Equity–Linked also holds a relatively small amount of Genta's common stock, which it received as a dividend on its preferred. The suit challenges the transaction in which Genta borrowed on a secured basis some $3,000,000 and received other significant consideration from Paramount Capital Asset Management, Inc., a manager of the Aries Fund (together referred to as ''Aries'') in exchange for a note, warrants exercisable into half of Genta's outstanding stock, and other consideration. The suit seeks an injunction or other equitable relief against this transaction.

* * * [F]rom a realistic or finance perspective, the heart of the matter is the conflict between the interests of the institutional investors that own the preferred stock and the economic interests of the common stock * * *. * * * [T]he facts out of which this dispute arises indisputably entail the

imposition by the board of (or continuation of) economic risks upon the preferred stock which the holders of the preferred did not want, and * * * those facts do not constitute a breach of duty. While the board in these circumstances could have made a different business judgment,[2] in my opinion, it violated no duty owed to the preferred in not doing so. The special protections offered to the preferred are contractual in nature. See Ellingwood v. Wolf's Head Oil Refining Co., Del.Supr., 38 A.2d 743, 747 (1944). The corporation is, of course, required to respect those legal rights. But, aside from the insolvency point just alluded to, generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, etc., of preferred stock, where there is a conflict. See Katz v. Oak Industries, Inc., Del. Ch., 508 A.2d 873, 879 (1986). The facts of this case, as they are explained below, do not involve any violation by the board of any special right or privilege of the Series A preferred stock, nor of any residual right of the preferred as owners of equity.

* * * [T]hat is, I think, the heart of this matter. But the case has been presented, not as a preferred stock case, but as a ''Revlon'' case. * * * Relying upon the teachings of Paramount Communications v. QVC Network, Del.Supr., 637 A.2d 34 (1993), plaintiff argues that the board did not satisfy the relevant legal test because, it says, defendants did not search for the best deal. Specifically, the board did not ask the holders of the preferred stock what they would have paid for the consideration given by Genta to Aries. The preferred, plaintiff says, would have ''paid more'' and that would have benefitted the common or all equity. For the reasons set forth below * * * I conclude that the directors * * * breached no duty owed to the corporation or any of the holders of its equity securities.

I.

A. The Company: Genta was started in 1988 by Dr. Thomas Adams who has served since as its CEO and Chairman. It is in the bio-pharmaceutical business with its principle facility in San Diego. It has three components. First, it owns various intellectual property rights with respect to a genetic research area known as ''antisense''. Its antisense activities involve research, development, and testing directed towards developing a treatment for certain cancers. It has developed no commercial products from its intellectual properties. Second, through a wholly owned subsidiary, JBL Scientific Inc., Genta manufactures generic chemicals, pharmaceuticals, and intermediate products used by bio-pharmaceutical companies, including its own antisense business. It has a positive cash flow. Thirdly, Genta owns a 50% interest in a joint venture with SkyePharma PLC, which is involved in the development of a new oral drug delivery technology. It has

2. See Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., Del. Ch., C.A. No. 12150, Allen, C. (Dec. 30, 1991) Mem. Op. at n. 55 (where foreseeable financial effects of a board decision may importantly fall upon creditors as well as holders of common stock, as where corporation is in the vicinity of insolvency, an independent board may consider impacts upon all corporate constituencies in exercising its good faith business judgment for benefit of the ''corporation'').

not yet produced a positive cash flow. Indeed, both the antisense and drug delivery products are still entirely at the development stage. The company has never made a profit and has expended almost $100 million on research, development, and overhead since its founding. While this sounds bleak, nevertheless, it is the case that some of its technologies, if they could be developed into marketable products, would be exceptionally useful and valuable.

* * *

B. Capital Structure: As of January 28, 1997, the capital structure of Genta comprised 39,991,626 shares of common stock; 528,100 shares of Series A preferred stock; and 1,424 shares of Series C preferred stock outstanding. The original investment by the common stock had been about $58 million. The Series A preferred had originally invested $30 million. Something less than $10 million had been raised from later classes of preferred, much of which had subsequently been converted to common stock. The Series A preferred stock was issued in 1993 at $50 per share. It carries a $50 per share liquidation premium ($30 million in total). It had a dividend paid in common stock for the first two years and earns a $5 per share cumulative dividend, payable if, as, and when declared for subsequent years. In the event of a ''fundamental change,'' holders of Series A preferred stock would have an option to have their shares redeemed by the company at $50 per share, plus accrued dividends. Among events that would constitute a ''fundamental change'' would be a delisting of Genta stock on the Nasdaq.[6] More important for this case, Genta was contractually obligated to redeem the Series A shares on September 23, 1996 with cash or common stock and, if common stock, to use its best efforts to arrange a public underwriting of the common stock. This obligation, and the factors which prevented the redemption from occurring, occasioned the long negotiation with the holders of the preferred stock discussed below.

In addition to the foregoing, the preferred had certain governance rights. For example, the holders were entitled to notice of board meetings and were to be given rights to inspect corporate books and visit and observe board meetings.

C. Chronic Financial Problems: The lack of a product that generates substantial positive cash flows, coupled with an active research and development agenda, has lead to a notable (later, a somewhat desperate) search for sources of new investment capital. Genta engaged in a series of small equity placements in 1995 and 1996. * * * By the spring of 1996, it became quite apparent that as of September the company would have insufficient cash to redeem the preferred with cash and, that while common stock would be available, the company's good faith efforts to arrange a firm

6. A fundamental change would occur if there were a change in voting power of the company greater than 60%, a merger or transfer of the joint venture, or a substantial reduction of the public market for Genta common stock, as would occur in the event of a delisting from Nasdaq. An occurrence of a fundamental change due to a delisting from Nasdaq became a realistic threat as of December 1996. In the event of a fundamental change, the Series A shareholders would become creditors of the company and could potentially require the company to enter into bankruptcy proceedings.

commitment underwriting of that stock would in all likelihood have no reasonable prospect of success. Genta's board retained Alex. Brown & Sons Incorporated (''Alex. Brown'') to advise and assist the company in dealing with its inability to provide either cash or an assured underwriting of its common stock. In addition, the company asked Alex. Brown to attempt to locate potential sources of equity financing * * *.

D. Series A Committee Organized: In July 1996, plaintiff and five other investors holding Series A stock created the Series A Preferred Ad Hoc Committee to act as a bargaining agent with the company. [Meetings among the Committee, company officers, and Alex. Brown followed. Alex. Brown proposed a combination of (1) a cash sale of the antisense business and JBL, (2) a purchase by Genta of SkyePharma's interest in the joint venture in exchange for a placement in SkyePharma of a majority holding of Genta common, (3) an exchange of a minority holding of Genta common for all of the preferred. The Series A committee rejected this, along with other proposals that contemplated a disposition of assets without also providing for an immediate cash distribution. The Committee took the position if a suitable transaction were not proposed, the preferred would just as soon] ''wait and see if [Genta would] run out of money and then get [delisted]. . . .'' A delisting would give the preferred stock the legal right to the liquidation preference, allowing them to place the company into bankruptcy. [The company, meanwhile, had made its distressed circumstances known to the public in a series of press releases.]

* * *

E. Genta's Inability to Redeem or Convert Preferred: In September, Genta gave the Series A holders an option to convert their shares into common stock, but could provide no underwriting in any event. Genta offered to effectuate the conversion or to permit the preferred stock simply to remain outstanding for the time. Due to the low market price of Genta's common stock, (less than $1 per share) an immediate conversion into common stock was not an economically attractive option. Only 10% of the Series A stockholders elected to convert into common stock without an underwriting. The remaining Series A shareholders continued to negotiate with Genta concerning its restructuring proposal.

F. Multiple Track Investigations: [During October and November, Genta engaged LBC Capital Resources, Inc. (''LBC'') to find a new source of equity capital. Alex. Brown, which remained involved, made a second recapitalization proposal to the Committee. This proposal, like its predecessor, failed to provide for outright sales of Genta's assets followed by a distribution of proceeds. Accordingly, the Series A committee rejected it as well. The Genta board, meanwhile, opposed a proposed sale of the antisense assets being advocated by the Committee. Such a sale, said the board, would result in the breach of a contract with a third party, Gen–Probe. In addition, the proposed purchaser, Isis, had refused to assume any of Genta's liabilities.]

* * * On November 14, 1996, Genta issued a Form 10–Q stating that:

> The Company will run out of its existing cash resources in December of 1996. Substantial additional sources of financing will be required in order for the Company to continue its planned operations thereafter.... If such funding is unavailable, the Company will be required to consider [various alternatives] ... including, discontinuing its operations, liquidation or seeking protection under the federal bankruptcy laws.

On November 18, Genta's common stock price closed at $.31 per share. As a result, on November 19, Nasdaq announced that Genta's common stock would be delisted unless by December 3 it submitted a plan with respect to how it would comply with Nasdaq's listing requirements concerning net worth. * * *

[Meanwhile, LBC's search had yielded a potential equity investor, Aries. LBC proceeded to discuss a deal with Aries on the working assumption that Genta could issue up to 60 million additional shares of common stock without triggering the ''fundamental change'' provision of the preferred stock designations and obligating Genta to repurchase the preferred.]

G. Aries Proposal: Dr. Rosenwald [the CEO of Aries] presented the following financing proposal to Genta at the November 26 meeting. Aries would lend Genta between $5–6 million in exchange for a secured note plus securities consisting of a new class of preferred stock (special preferred stock with embedded alternative rights convertible into common stock at $.10 per share) and warrants to buy common stock at an exercise price of $.10 per share. The letter setting forth this proposal stipulated that Aries's immediate control of the Genta board was a non-negotiable term of the proposed transaction.[21]

Adams responded that Genta sought (1) a two tiered financing (i.e., some immediate cash infusion), (2) a higher exercise price on any warrants ($.25 per share) granted in consideration of the second tier financing, and (3) a more limited board presence, permitting Aries to designate only one director and two observers. Two days later, Aries agreed to the two tiered financing structure and a $.20 second tranche exercise price for the warrants. It continued to insist upon a contract right to designate a majority of the board.[22]

H. December Negotiations: [Aries and Genta continued to negotiate during December, with Rosenwald making a formal presentation to the Genta board on December 30. A confidentiality rule prevailed—neither Alex. Brown nor the Series A committee had knowledge of Aries' interest in Genta, the proposed transaction, the ongoing negotiations, or the board

21. Aries, which typically makes non-passive investments, has a history of assisting in successful turn arounds of financially troubled bio-pharmaceutical companies.

22. After further negotiations, discussed below, Aries agreed to a forfeiture of board control in the event that additional second tier financing was not arranged by Aries for Genta. In addition, Aries agreed to an increase in the exercise prices for the first and second tranches to $.15 and $.30 per share respectively.

presentation. The first disclosure occurred after the board's January 28 meeting.

[The Series A committee, meanwhile, made a formal restructuring proposal to Genta. This entailed (1) the sale of JBL for cash with proceeds escrowed for the preferred, (2) the sale of the antisense assets with most proceeds being held for the preferred and the remainder made available to the common provided certain performance conditions were met, and (3) the sale of the rest of Genta to SkyePharma for (a) $3 million in SkyePharma stock to be distributed to the preferred, and (b) a 29 percent interest in the joint venture of which 20 percent was to go to the Genta common. The Committee proposal offered no solution to the problem of the Gen–Probe contract.]

As of December 20, it had become apparent that Genta might be forced into bankruptcy if it did not fairly promptly effectuate one of the transactions on the table. Genta's bankruptcy counsel attended its December 20 board meeting at which the status of Genta's negotiations and the ongoing Nasdaq delisting proceedings were discussed. As expected, on December 21, Nasdaq denied Genta's request for continued listing, but the actual delisting was temporarily suspended until after a formal hearing could be held on January 23.

* * *

I. January 1997: [The board considered all options at its January 13 meeting, including a possible chapter 11 filing and a revised proposal that the Series A committee had put on the table. The revised proposal provided less for the common than had its predecessor, reflecting unfavorable revisions in the terms of some of the proposed asset sale transactions. After the meeting, the Alex. Brown representative noted that the proposal's "punitive" treatment of the common made it unlikely that it ever could garner the vote of the common required by section 271. Thereafter, in advance of a meeting on January 26, the board members received LBC's informal written evaluation of the Committee proposal and the Aries transaction, which concluded that Aries was the "fairer" choice. Adams also submitted an analysis according to which Genta possessed a $59 million going concern value.]

On January 23, Genta and an Aries representative participated in the anticipated Nasdaq delisting hearing. As a result of the hearing, Nasdaq decided again to postpone the threatened delisting of Genta's stock. Genta was, however, informed that it would be delisted in the future unless it increased its net tangible assets and met other requirements.[34]

As of the January 26 meeting, it had become clear that Genta had to complete a financing transaction rapidly, or else face bankruptcy. Recognizing that Genta would not have sufficient cash for its payroll due on

34. On February 4, 1997, after the challenged Aries transaction had already been entered into and announced, Genta was removed from the Nasdaq National Market and was instead listed on the Nasdaq SmallCap Market. At that time, Genta was informed that it would be removed from the SmallCap listing as well unless it increased its net tangible assets by April 7, 1997.

February 1, Genta's bankruptcy lawyers had begun preparing the necessary papers to file for bankruptcy on January 29. At this juncture, faced with an imminent decision, Dr. Adams informed the board that he opposed the [Series A] restructuring proposal in its present form.[35] [Meanwhile, the Aries offer was set to expire as of January 28.]

J. Aries Transaction: On January 28, 1997, the Genta board unanimously approved the Aries transaction. [The letter of intent that the board approved at the meeting called for a two-step financing.] The first step, which by the time of trial of this case had already occurred, involved Aries loaning Genta $3 million in cash. In exchange, Aries received convertible secured bridge notes with a $3 million face value, 7.8 million Class A warrants with a $.001 per share exercise price, and 12.2 million Class B warrants with a per share exercise price of $.55.[40] The bridge notes are immediately convertible into 600,000 shares of Series D convertible preferred stock with a $10 stated value per share.[41] In the event that Aries converts this preferred stock, Aries would receive 20 million shares of Genta common stock. Together the transaction offers Aries the right to acquire 40 million shares of Genta common stock—a controlling interest in the company.

In addition to this consideration in the form of debt and equity, Aries received an immediate contractual right to require the Genta board to cause a sufficient number of its designees to be added to the board so as to constitute a majority of the board.[43] In the event that Aries does not satisfy its future obligations to raise additional capital (the second tier financing), however, this right will terminate. That is, pursuant to the terms of the second tranche of this financing, Aries has agreed to use its "best efforts" to arrange between $2.5 to $12 million in additional financing for Genta.[44]

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35. Director Klem [the other inside director] had concluded as well that the final Series A proposal was unacceptable, identifying five key problems: the impact on the common stockholders, the plan to escrow the JBL proceeds in a manner which could enable the Series A holders to force Genta into bankruptcy, the remaining Gen–Probe issue, the fact that it would be unfair to give an estimated $85 million in value (on his assumption about values based on the data supplied by LBC) to the Series A holders while the common received zero value, and the failure to resolve the threat of a future Nasdaq delisting. In his opinion, the Aries proposal would give the common stockholders between $1 to $2 in value per share.

40. Both the A and B warrants are immediately exercisable and have a term of five years. The effective average price of these warrants is actually $.15 per share of common stock, not $.25. I conclude this because, pursuant to the financing agreement, the failure of Genta's stockholders to approve the transaction would constitute an event of default, entitling Aries to convert up to $300,000 of its secured debt into three hundred million shares of Genta common stock (or in that event 90% of the common). In effect, this coercive default provision guarantees stockholder approval, which may be required under Nasdaq listing standards. Once the Aries deal has received stockholder approval, or there has been a decision that such approval is not required, all of the warrants can be exchanged for new warrants with the same terms, but convertible at $.15 per share.

41. The initial conversion price for such notes is $5 per share. The Series D preferred stock is then convertible into common stock at $.15 per share.

43. Aries has not exercised this right yet, and has indicated that it does not intend to do so while this litigation is pending.

44. Specifically, Aries agreed to use its "best efforts" to effect the purchase of a minimum of 25 up to a maximum of 75 "units," which will be sold at $100,000 per unit. Such

If, within six months following the effective date of the agreement, Aries has not located at least $3.5 million of additional financing for the company, it will lose its right to designate a majority of the board. The agreement does not state the minimum terms upon which an acceptable financing can be made in order to satisfy Aries's obligation, but requires board approval and permits Genta to opt for alternative financing if it is available on preferable terms.

In addition to the financial terms of the deal, Aries represented to Genta that it did not intend to liquidate the company and would use its best efforts to continue Genta's antisense business. Aries did not make any representations or side agreements concerning the continued employment of Dr. Adams or other Genta board members. To the contrary, the testimony is that Dr. Adams told Aries that it should consider hiring a new CEO.

K. Equity–Linked's March 3 Proposal: Immediately prior to the hearing in this action, Equity Linked delivered a proposal to Genta that offered to extend a $3.6 million loan to Genta on the same terms as those reflected in the Aries transaction. This offer appears to have been an attempt by plaintiff to demonstrate that it would have been willing to do the same deal on terms at least as favorable as those offered by Aries.

II.

The broad question is whether the foregoing facts constitute a breach of duty by the directors of Genta. The theory of the original complaint was that the Aries transaction represented a bad faith exercise of corporate power; that the purpose of the transaction was simply to protect the employment of the incumbent officers * * *.

The claim now is that the board ''transferred control'' of the company and that in such a transaction it is necessary that the board act reasonably to get the highest price, which this board did not do. Plaintiff urges that the special duty recognized in Revlon, Inc. v. MacAndrews & Forbes Holding, Inc., Del.Supr., 506 A.2d 173 (1986), arose here because (1) Aries has a contract right to designate a majority of the Genta board and (2) Aries acquired warrants that if exercised would give it the power to control any election of the Genta board. Thus, this transaction is seen as similar to the noted case of Paramount Communications Inc. v. QVC Network Inc., Del.Supr., 637 A.2d 34 (1993). Plaintiff claims that the board hid the fact that control might be for sale, instead of announcing it and creating price competition respecting it. In support of the assertion that the board could have done better for common stockholders, like themselves, plaintiff points to the litigation produced alternative proposal of the Series A preferred stock. The idea is that this alternative is financially a little better and that if the directors would have met their ''Revlon duty'' then, this or another better alternative would have come to light. In this way, plaintiff claims the interests of all holders of equity securities would have been better off because Genta would have gotten greater value.

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units will have three components, including $70,000 of senior secured convertible notes, 3,000 shares of preferred stock, and 333,334 warrants. The notes and warrants will both have an exercise price of at least $.30 per share of common stock.

* * * [I]t is my opinion * * * that the Genta board fully satisfied its obligations of good faith and attention with respect to the Aries transaction. * * *

A.

''Revlon Duties'' and a Change in Corporate Control: In Paramount Communications, Inc. v. QVC Network Inc., the Delaware Supreme Court considered a series of cases dealing with the fiduciary duties of corporate directors when directors authorize a transaction that has the effect of changing corporate control. The most prominent of these was the 1986 opinion in Revlon, Inc. v. MacAndrews & Forbes Holding, Inc. That case had been widely thought to announce special directorial duties in the event of a ''sale'' of the corporation. The specific character of that rule however was not entirely clear, but it was generally taken to be that in certain circumstances (loosely a ''sale'' of the company) directors must maximize the current value of the corporation's stock; they may not exercise a judgment to choose less when more is offered. But this broad generalization masks more questions than it answers. In fact the meaning of Revlon—specifically, when its special duties were triggered, and what those duties specifically required—were questions that repeatedly troubled the bench and the bar in the turbulent wake of the Revlon decision. * * *

* * *

This existing uncertainty respecting the meaning of ''Revlon duties'' was substantially dissipated by the Delaware Supreme Court's opinion in Paramount. The case teaches a great deal, but it may be said to support these generalizations at least: (1) where a transaction constituted a ''change in corporate control'', such that the shareholders would thereafter lose a further opportunity to participate in a change of control premium, (2) the board's duty of loyalty requires it to try in good faith to get the best price reasonably available (which specifically means that the board must at least discuss an interest expressed by any financially capable buyer), and (3) in such context courts will employ an (objective) ''reasonableness'' standard of review (both to the process and the result!) to evaluate whether the directors have complied with their fundamental duties of care and good faith (loyalty).

* * *

B.

Application of Paramount to the Aries Transaction: The questions that Paramount frames for this case are essentially two. First, is the Aries transaction a ''change in corporate control'' that triggers special directorial duties and that requires enhanced judicial review, under a reasonableness standard. Second, if it is, do the facts found, set forth above, constitute either (1) bad faith or insufficiently informed action or (2) unreasonable action given the type of transaction that was under consideration.

1. Does the Aries transaction trigger special board duties? I assume for purposes of deciding this case, without deciding, that the granting of immediately exercisable warrants, which, if exercised, would give the

holder voting control of the corporation, is a transaction of the type that warrants the imposition of the special duties and special review standard of Paramount.

2. What are the special duties that are triggered? The duties that devolve upon the board when it approves a transaction having a change in corporate control effect (and here I mean specifically, as in Paramount, where corporate action plays a necessary part in the formation of a control block where one did not previously exist), is to take special efforts to be well informed of alternatives, and to approve only a transaction that seeks reasonably to maximize the current value of the corporation's equity. That is the gist of the Revlon state: to act reasonably to maximize current, not some future, value. * * * The enhanced information obligation, occasioned by the gravity of the triggering transaction, may be satisfied through an auction, through a "market check," or perhaps in other ways, but it is fundamental that the board's effort to be informed must be active and reasonable.

3. Have the director-defendants failed to reasonably attempt to advance the current interests (or value) of the holders of the corporation's equity securities? The board did not negotiate with the preferred stock with respect to a transaction of the kind it was attempting to find elsewhere. Thus the question: Did this violate the board's duty to be especially active and reasonable in searching for relevant information? Secondly, assuming, without deciding, that the March 3 proposal by the preferred stock was on better terms than the Rosenwald/Aries deal—in that it offered a somewhat greater first tranche credit—has the board failed reasonably to maximize the current value of the firm's equity?

In my opinion, the answer to both of these questions is no.

With respect to the first question, even though no offer was made to the preferred to permit them to acquire control, I cannot conclude that the board was not fully informed of the company's relevant alternatives (i.e., relevant to the board's good faith business plan) by the time it authorized the Aries transaction. The ultimate choice for the board was correctly understood. It was not between the Aries transaction and an alternative similar transaction at a "higher price" or on better terms, of which the board did not know because of its inattention (or otherwise). The real choice was between (1) a transaction that attempted to finance a future for the company in which products might be developed and brought to market, and (2) a transaction that treated the enterprise (perhaps correctly) as a failed effort and would therefore involve the sale of its assets and a distribution of the proceeds, largely if not entirely, to the preferred stock.[49] After a lot of effort the board saw this choice as the choice between accepting the Aries transaction, on one hand, which offered some prospect

49. It is not part of the court's responsibility to evaluate which course of action was wiser from the point of view of the convertible preferred or the common. I would have to accept the notion that the holders of the preferred stock are in the only position to say with authority what is in their best interest. Equally clearly, the common had an adverse interest to the preferred if the preferred didn't want (as they apparently did not want) to role the dice on the future.

of further credit being raised, some bio-tech expertise being brought to bear by the investor, and some meaningful enhancement of the prospects of the company for survival, product development, and ultimate financial success, and, on the other hand, accepting the final, take it or leave it proposal of the Series A preferred stock, which meant that the common would get essentially nothing and the corporation would never see the future benefit of the exploitation of its intellectual property.

The charge of failure to search appropriately for alternatives that would have been more beneficial to the owners of the company's equity securities is deeply unconvincing on the evidence. The evidence is completely inconsistent with the notion that some other (third) party, who was unknown, would have offered a better deal to Genta. The board, with the advice and assistance of professional advisors, had thoroughly explored that possibility. The more plausible supposition is that if the board had gone back to the Series A preferred stock once its deal with Aries was substantially negotiated, the preferred would likely have authorized a proposal like the one that the holders ultimately put forth in the litigation, which I will assume is in certain respects superior. Nevertheless, I conclude that the board's failure to afford the preferred stock an opportunity to meet or exceed the Aries proposal was quite reasonable in the circumstances (some reasonable minds may have thought it likely to be futile and wasteful).

The Genta board had been dealing with the preferred stock for some time in a rather intense way. The board knew, or had good reason to believe it knew, what were the business goals of the preferred with respect to its investment in Genta. The preferred quite certainly were interested in taking as much money out of Genta as possible, as soon as possible. * * *

Moreover, the Series A knew that management was looking for financing. There were press releases to that effect. Yet they were unwilling to put in more money. The preferred is of course not to be criticized for that. They have every right to send no good dollars after bad ones. Indeed, they had the right to withhold necessary consents to salvage plans unless their demands were satisfied. But when plaintiff now contends that the Genta board was required by fiduciary duty to the company's common stockholders to go back to the Series A preferred after finding an investor willing to do what the Series A sought to prevent, I cannot agree. * * *

It was quite reasonable for the Genta board to conclude that, if the policy of the board was to try to find a way to finance further research and development in order to attempt to benefit the residual owners of the firm, that any proposal that transferred corporate control or potential control to the preferred stock was a highly dubious way to achieve that goal.

Why a Revlon auction or other bidding with the preferred anticipating would not maximize value of the common stock in the situation faced by Genta's board: A bidding contest between the Series A and a new investor interested in developing Genta's intellectual property would be a poor way to attempt to maximize either the present value or some future value of the common stock in these particular circumstances, I assume, as the facts allow, that the Series A liquidation premium is greater than the liquidation value of the firm—but that the preferred stock has no legal right to force a liquidation. In that event, the preferred would have a bidding advantage and would use it to deprive the common of their power to exploit the preferred that the common currently possesses. Assume, for example, that the present value of the firm's prospects as a going concern would be only $9 million (net), which is also its liquidation value. Assume that in an open bidding contest, a well informed bidder will offer the company something less than 3 million for a 51% interest (i.e., $9mm + $3mm = $12mm divided by 2 = $6mm; but since in liquidation the common stock would be worthless, the bidder would be unlikely to bid the maximum $6mm value on these assumptions). Assume such a $3mm bid would permit the common stock some further opportunity to see a payoff in the company labs and in the marketplace. Now assume that a bidding contest occurs in which the preferred takes part. What will probably happen? The preferred's aim might be simply to liquidate the company and take all of the net proceeds and apply it to its preference. This will prevent its exploitation by the common and cut its losses. To accomplish that goal, the preferred could easily pay in an auction up to $21 million ($30 million liquidation preference minus present net liquidation value) because that amount would go into the company's treasury but could be immediately restored to the preferred when it exercised its voting power to cause the liquidation of the firm.

To generalize, the existence of a "below water" liquidation preference would allow the preferred to out bid an arm's length bidder for Genta's assets and defeat an attempt to exploit the company's properties (and not incidentally, an attempt to exploit the preferred in its current situation) for the benefit of the common stock. What the board did, in effect, was to try on behalf of the common to exploit the preferred—by imposing risks on them without proportionate opportunity for rewards. That the preferred is open to this risk legally, is a function of the terms of its security. I think it is perfectly permissible for the board to choose this course in these circumstances. To engage in a Revlon auction or otherwise allow the preferred to out bid a third party, would be to defeat this legitimate strategy.

* * *

With respect to the second question, if we assume that Genta's board was operating under the unusual gravitational pulls of planet Revlon, we must acknowledge that the board is supposed in such "sale of control" circumstances, to have the single aim of maximizing the present value of the firm's equity. That requirement is very clear when, for example, one bidder, offers an all cash deal and another offers all cash as well, but less money. It is tolerably clear when one bidder offers cash and another offers cash and widely traded securities, the package being worth less when measured by dependable markets. But what that requirement means in this setting, where (1) the transaction is not a merger or tender offer with a "price" per share at all, and (2) the transaction (or alternatives now advanced) are not otherwise easily reduced to a present value calculation, is not obvious. What is clear is that the Genta board was striving to maximize the possibility of the common stock participating in some ''upside'' benefit from the commercial development of the company's intellectual properties. It is clear too that the course it took to do that arguably was superior to an alternative in which the preferred acquired control, because the preferred had a financial incentive to liquidate the firm immediately, thus depriving the common of any current value. Thus, unlike two competing cash transactions or transaction in which widely traded securities are offered, the alternatives that plaintiff poses are rich with legitimate, indeed unavoidable, occasions for the exercise of good faith business judgment. Where judgment is inescapably required, all that the law may sensibly ask of corporate directors is that they exercise independent, good faith and attentive judgment, both with respect to the quantum of information necessary or appropriate in the circumstances and with respect to the substantive decision to be made.

This principle has application here. The Genta board had a business goal of trying to maintain an equity participation for the common stock in its promising intellectual properties. It mattered to this strategy who was the controlling shareholder. While the Genta board hardly could (or at all events did not) negotiate binding provisions assuring that its goal would be obtained, it could and did exercise an informed good faith judgment concerning it. It took steps demonstrating its good faith efforts. First, it negotiated with Dr. Rosenwald for the second tranche of financing. Second, it received an undertaking from Dr. Rosenwald that he did not intend to liquidate the company and would try to develop the antisense business. Third, the economic incentives of Aries were inherently different than those of the Series A preferred stock and the board could recognize and depend to some extent on those differences. That is, the Series A inherently have some interest in protecting their liquidation preference. Aries, like other owners of only common, has an incentive to employ the remaining capital and that which can be raised, to commercially exploit Genta's properties.

* * *

In short, the facts of this case clearly do not look like a situation in which, from the common stock's perspective, ''there is no tomorrow,'' and the board ought not be recognized as having discretion to prefer what it sees as a ''longer term value'' over a higher present value. The court would have no basis to conclude that the immediate value of the common would in fact be greater had an alternative of the kind presented by the preferred somehow been put in place in January.

Thus, I conclude in the circumstances disclosed by the balance of the credible evidence, that the Genta board concluded in good faith that the corporation's interests were best served by a transaction that it thought would maximize potential long-run wealth creation and that in the circumstances, including the potential insolvency of the company and the presence of a $30 million liquidation preference, the board acted reasonably in pursuit of the highest achievable present value of the Genta common stock, by proceeding as it did.

NOTE: CASE FOR COMPARISON

Fait v. Hummel, 333 F.3d 854 (7th Cir.2003), shows that appropriately drafted contracts can facilitate the transfer of control from the entrepreneur to venture capital investors in the event of substandard performance.

The case concerned Pentech, a pharmaceutical company in the business of developing drugs. Pentech issued Series A preferred shares to a number of investors, pursuant to an investor rights agreement that gave them the right of first refusal on any newly issued stock. The agreement also gave the Series A the right to elect two of Pentech's five board members and the power to elect four out of five for a period of 2 years if Pentech violated certain covenants in the agreement. Pentech went on to violate the covenants and the Series A holders exercised their rights to elect four of the five directors. As a result, Fait, Pentech's founder, lost his seat on the board. The preferred also removed Pentech's CEO, El–Rashidy. El–Rashidy thereupon resigned from the board. (Fait and El–Rashidy together owned two-thirds of Pentech's common stock.) This left a board of four, all nominated by the Series A. Three of the four directors held no Series A and thus were "independent" of the Series A.

Pentech was close to insolvency and needed new equity capital. The "independent" and thus "disinterested" majority of the board approved an offer of 4,220,921 new shares of common stock for $1/share. The Series A holders exercised their right of first refusal under the investor rights agreement and bought all of the shares. Fait attacked the stock offering as an invalid self-dealing transaction. Fait claimed that the deal unfairly diluted the interest of the common shareholders and that the $1/share price was inadequate. Fait also claimed that Pentech would have been better off selling junior preferred stock to a new investor, Julphar Pharmaceuticals. Julphar had been discussing the possibility of buying up to $20 million worth of junior preferred stock from Pentech, but the talks had broken down. Fait claimed that the board gave up on the deal prematurely, preferring a stock offering that gave the Series A permanent control.

The Seventh Circuit, applying Illinois law, concluded that Fait had not met the burden of proving that the offering was not fair. Fait's theory was that the stock offering failed as a self-dealing transaction because the disinterested directors who approved it lacked knowledge of all material facts. More particularly, Fait argued that the disinterested directors, whose expertise lay in pharmaceuticals, lacked the requisite business knowledge and should have hired outside experts. The court, noting that the directors knew quite a bit about the company and its financial situation, ruled that Fait had not met his burden of proof.

NOTE: OPPORTUNISM

1. *Venture Capital Exposure to Entrepreneur Opportunism.*

Adams, in which the entrepreneur has clear control of both the boardroom and the votes, presents an unusual case. In the more usual case of a split board with a tie-breaking director, opportunistic stripping of preferred rights and preferences to benefit the entrepreneur seems unlikely. Given an extended dispute, the venture capitalist will be safe as long as it has voting control at shareholders' meetings, and in most cases it will have the votes.

But there remain, as in *Adams*, a significant number of minority-vote venture capitalists. To what extent are they threatened by opportunism from majority vote entrepreneurs due to their status as preferred holders? The primary limitations on exposure are built into the transactions' overall economic structure. These deals have an intermediate duration, with the entrepreneur being required to raise cash to redeem the preferred in the event of an unfavorable outcome. So the window for opportunism opens in only a minority of cases and stays open for only a short period. Of course, *Adams* shows how a majority-vote entrepreneur can strip value even during this short period.

The degree to which value and rights can be stripped in this minority of cases depends on fine points of contracting practice. In a first round financing, covenants in the investor rights agreement should provide adequate protection for the venture capitalist. In a second round financing without an investor rights agreement, as in *Adams*, the venture capitalist must rely on the charter. The standard venture capital preferred contract forms provide for class votes in respect of adverse charter amendments, increases in the number of authorized shares, and the authorization of preferred classes of higher priority. Mergers are treated separately under a one-size-fits-all term. A merger is treated as a liquidation, triggering a right to redeem the preferred if the ''stockholders of the Company immediately prior to [closing of the transaction] own less than 50% of the Company's voting power'' thereafter. If the merger is treated as a liquidation, a class vote also is provided for. If the merger is not treated as a liquidation, no class vote is provided for.

This one-size-fits-all term is fairly effective, even as it falls a step short of perfection. The term manifestly is designed to overrule *Rothschild v. Liggett*, supra, the Delaware ruling that a cash out merger is not a liquidation. Where all of the shares of transferor firm in the merger are cashed out, the term manifestly achieves its intended purpose. The preferred liquidation rights become immediately exercisable and the preferred gets a class vote that allows it to veto the merger. But the preferred with a minority of the overall shares will not be protected under this provision in all cases.

2. *Entrepreneur Exposure to Venture Capital Opportunism.*

Opportunism is a problem whenever there is a majority stockholder. Since the venture capitalist has a voting majority most of the time, the entrepreneur is a potential victim. Indeed, by the numbers, he or she is the most likely victim. Here is the scenario of woe. The start up has created value, but not enough to support exit through an IPO or a lucrative third party sale. The venture capitalist has liquidity needs and loses patience, using its control power to force a third party sale yielding a modest sum. The sale is structured as a merger and the charter treats mergers as liquidations. All of the proceeds accordingly go to the venture capitalist because the liquidation value of the preferred exceeds the merger consideration. The purchaser has no use for the entrepreneur, and terminates his or her employment. The entrepreneur emerges with at best crumbs off the table, looking for work. The venture capitalist walks away with the value, value created by the entrepreneur.

The venture capitalist of course takes the position that a deal is deal. Fried and Ganor, Agency Costs of Venture Capital Control in Startups, 81 N.Y.U.L.Rev. 967 (2006), responds that venture capitalist eagerness to sell can implicate welfare losses. In their picture, the venture capitalist may have an incentive to favor a low-risk, low value exit over a high-risk, high value strategy that would maximize value for the shareholders as a group. They contend that the standard remedies against value-destroying exercises of control power—fiduciary duties, shareholder voting, appraisal rights, and reputational concerns—will avail the entrepreneur little.

How likely is that a venture capitalist will force a sale to a buyer that will so misuse the start up assets so as to sacrifice welfare in the long run? For evidence that venture capitalists sometimes face pressure to generate liquidity events, see Masulis and Nahata, Venture Capital Conflicts of Interest: Evidence from Acquisitions of Venture–Backed Firms, forthcoming, J. Fin. & Quant. Anal. How likely is it that the entrepreneur behind a start up that fails to make the IPO stage and is worth less the redemption value of the venture capital preferred will argue in good faith that his or her continued control maximizes economic welfare?

In re Trados Incorporated Shareholder Litigation

Delaware Court of Chancery, 2009.
2009 WL 2225958.

■ CHANDLER, CHANCELLOR.

This is a purported class action brought by a former stockholder of Trados Incorporated (''Trados,'' or the ''Company'') for breach of fiduciary duty arising out of a transaction whereby Trados became a wholly owned subsidiary of SDL, plc (''SDL''). Of the $60 million contributed by SDL, Trados' preferred stockholders received approximately $52 million. The remainder was distributed to the Company's executive officers pursuant to a previously approved bonus plan. Trados' common stockholders received nothing for their common shares.

Plaintiff contends that this transaction was undertaken at the behest of certain preferred stockholders that desired a transaction that would trigger their large liquidation preference and allow them to exit their investment in Trados. * * *

As explained below, plaintiff has alleged facts sufficient, at this preliminary stage, to demonstrate that at least a majority of the members of Trados' seven member board were unable to exercise independent and disinterested business judgment in deciding whether to approve the merger. Accordingly, I decline to dismiss the breach of fiduciary duty claims arising out of the board's approval of the merger. * * *

I. BACKGROUND

A. The Parties

Before the merger, Trados developed software and services used by businesses to make the translation of text and material into other languages more efficient. Founded in 1984 as a German entity, Trados moved to the United States in the mid–1990s with the hope of going public, and became a Delaware corporation in March 2000. To better position itself for the possibility of going public, Trados accepted investments from venture capital firms and other entities. As a result, preferred stockholders had a total of four designees on Trados' seven member board. Each of the seven members of Trados' board at the time of the board's approval of the merger is named as a defendant in this action.

David Scanlan was the board designee of, and a partner in, Wachovia Capital Partners, LLC (''Wachovia''). At the time of the merger, Wachovia owned 3,640,000 shares of Trados' Series A preferred stock (100% of that series) and 1,007,151 shares of Trados' Series BB preferred stock (approximately 24% of that series).

Lisa Stone was the board designee of Rowan Entities Limited and Rowan Nominees Limited RR (together, the ''Rowan Entities''), transferees of Trados' preferred stock held by Hg Investment Managers Limited (collectively, ''Hg''). Stone was a director and employee of both Hg Investment Managers Limited and the Rowan Entities. At the time of the merger, Hg owned 1,379,039 shares of Trados' common stock (approximately 4.3%), 2,014,302 shares of Trados' Series BB preferred stock (approximately 48.3% of that series), 5,333,330 shares of Trados' Series C preferred shares (all of that series), and 862,976 shares of Trados' Series D preferred stock (approximately 28.6% of that series).

Sameer Gandhi was a board designee of, and a partner in, several entities known as Sequoia. Sequoia owned 5,255,913 shares of Trados' Series E preferred stock (approximately 32% of that series).

Joseph Prang was also a board designee of Sequoia. Prang owned Mentor Capital Group LLC (''Mentor Capital''), which owned 263,810 shares of Trados' Series E preferred stock (approximately 1% of that series).

Wachovia, Hg, Sequoia, and Mentor combined owned approximately 51% of Trados' outstanding preferred stock. Plaintiff alleges that these preferred stockholders desired to exit their investment in Trados.

Two of the three remaining director defendants were employees of Trados. Jochen Hummel was acting President of Trados from April 2004 until September or October 2004, and was also the Company's chief technology officer. Joseph Campbell was Trados' CEO from August 23, 2004 until the merger. The remaining Trados director was Klaus–Dieter Laidig.

B. The Negotiations

In April 2004, the Trados board began to discuss a potential sale of the Company, and later formed a mergers and acquisitions committee, consisting of Stone, Gandhi, and Scanlan, to explore a sale or merger of Trados. Around the same time, the Company's President and CEO was terminated due to, among other issues, a perception by the rest of the board that Trados was underperforming. The board appointed Hummel as an interim President, but instructed him to consult with Gandhi and Scanlan before taking material action on behalf of the Company. In July 2004, Campbell was hired as the Company's CEO, effective August 23, 2004. Gandhi described Campbell as ''a hard-nosed CEO whose task is to grow the company profitably or sell it.'' At the time Campbell joined Trados, however, the Company was losing money and had little cash to fund continuing operations. At a July 7, 2004 meeting, Trados' board determined that the fair market value of Trados' common stock was $0 .10 per share.

In June 2004, Trados engaged JMP Securities, LLC, an investment bank, to assist in identifying potential alternatives for a merger or sale of the Company. By July 2004, JMP Securities had identified twenty seven potential buyers of Trados, and contacted seven of them, including SDL. By August 2004, JMP Securities had conducted discussions with SDL CEO Mark Lancaster, who made an acquisition proposal in the $40 million range. Trados informed Lancaster that it was not interested in a deal at that price, and Campbell formally terminated JMP Securities in September 2004.

In July 2004, Scanlan expressed concern that the executive officers of the Company might not have sufficient incentives to remain with the Company or pursue a potential acquisition of the Company, due to the high liquidation preference of the Company's preferred stock. The board instructed Scanlan to develop a bonus plan to address these concerns. This led to the December 2004 board approval of the Management Incentive Plan (the ''MIP''), which set a graduated compensation scale for the Company's management based on the price obtained for the Company in an acquisition.

Trados' financial condition improved markedly during the fourth quarter of 2004, in part due to Campbell's efforts to reduce spending and bring in additional cash through debt financing. By the time of the December 2004 board meeting, Trados had arranged to borrow $2.5 million from Western Technology Investment, with the right to borrow an additional $1.5 million.

Despite the Company's improved performance, the board continued to work toward a sale of the Company. In December 2004, Gandhi reported to Sequoia Capital that the Company's performance was improving, but that Campbell's ''mission is to architect an M & A event as soon as practicable.'' At a February 2, 2005 board meeting, Campbell presented positive financial results from the fourth quarter of 2004, including record revenue and profit from operations. As a result of its improved performance and the lack of an immediate need for cash, the board extended by six months the period during which it could obtain additional cash from Western Technology Investment.

In January 2005, SDL initiated renewed merger discussions with Campbell. Upon learning of SDL's interest, the Trados board expressed that it was not interested in any transaction involving less than a ''60–plus'' million dollar purchase price. Lancaster first discussed a transaction at $50 million, but later offered $60 million. At the February 2, 2005 meeting, the board instructed Campbell to continue negotiating with Lancaster under the general terms SDL proposed, including the $60 million price. In mid-February 2005, Campbell made inquiries with two other potential acquirers of Trados, but neither expressed any substantive interest.

In a theme that runs throughout his allegations, plaintiff alleges that there was no need to sell Trados at the time because the Company was well financed and experiencing improved performance under Campbell's leadership. For example, plaintiff contends that by February 2005 Trados was beating its revenue budget for the year, a trend that continued as Trados beat its revenue projections for the first quarter of 2005 and through the end of May 2005.

By February 2005, Campbell and Lancaster agreed to the basic terms of a merger at $60 million. Trados then re-engaged JMP securities, which plaintiff alleges acted as little more than a ''go-between.'' In April 2005, SDL and Trados signed the letter of intent for the merger at the $60 million price.

* * *

D. The Merger

The director defendants unanimously approved the merger, and on June 19, 2005 Trados and SDL entered into an Agreement and Plan of Merger. Of the $60 million merger price, approximately $7.8 million would go to management pursuant to the MIP, and the remainder would go to the preferred stockholders in partial satisfaction of their $57.9 million liquidation preference. Plaintiff alleges that the directors know both of these facts, and thus knew that the common shareholders would receive nothing in the merger. The merger was consummated on July 7, 2005.

Plaintiff alleges that Campbell and Hummel received benefits as a result of the merger. Campbell became a director of SDL and received $775,000 through the MIP, $1,315,000 in exchange for a non-compete agreement, and a $250,000 bonus. Campbell took $702,000 of his MIP compensation in SDL stock, and $73,000 in cash. Hummel became ''SDL's general manager of Europe, the Middle East, and Asia (technology division),'' and received $1,092,000 under the MIP, of which he took $436,800 in SDL stock and $655,200 in cash.

II. ANALYSIS

* * *

C. Fiduciary Duty Claims

Count I of the Complaint asserts a claim that the director defendants breached their fiduciary duty of loyalty to Trados' common stockholders by approving the merger. Plaintiff alleges that there was no need to sell Trados at the time because the Company was well-financed, profitable, and beating revenue projections. Further, plaintiff contends, ''in approving the Merger, the Director Defendants never considered the interest of the common stockholders in continuing Trados as a going concern, even though they were obliged to give priority to that interest over the preferred stockholders' interest in exiting their investment.''

* * *

* * * A plaintiff can survive a motion to dismiss under Rule 12(b)(6) by pleading facts from which a reasonable inference can be drawn that a majority of the board was interested or lacked independence with respect to the relevant decision.

A director is interested in a transaction if ''he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders'' or if ''a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders.'' The receipt of any benefit is not sufficient to cause a director to be interested in a transaction. Rather, the benefit received by the director and not shared with stockholders must be ''of a sufficiently material importance, in the context of the director's economic circumstances, as to have made it improbable that the director could perform her fiduciary duties ... without being influenced by her overriding personal interest...."

Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences. At this stage, a lack of independence can be shown by pleading facts that support a reasonable inference that the director is beholden to a controlling person or "so under their influence that their discretion would be sterilized."

Plaintiff's theory of the case is based on the proposition that, for purposes of the merger, the preferred stockholders' interests diverged from the interests of the common stockholders. Plaintiff contends that the merger took place at the behest of certain preferred stockholders, who wanted to exit their investment. Defendants contend that plaintiff ignores the "obvious alignment" of the interest of the preferred and common stockholders in obtaining the highest price available for the company. Defendants assert that because the preferred stockholders would not receive their entire liquidation preference in the merger, they would benefit if a higher price were obtained for the Company. Even accepting this proposition as true, however, it is not the case that the interests of the preferred and common stockholders were aligned with respect to the decision of whether to pursue a sale of the company or continue to operate the Company without pursuing a transaction at the time.

The merger triggered the $57.9 million liquidation preference of the preferred stockholders, and the preferred stockholders received approximately $52 million dollars as a result of the merger. In contrast, the common stockholders received nothing as a result of the merger, and lost the ability to ever receive anything of value in the future for their ownership interest in Trados. It would not stretch reason to say that this is the worst possible outcome for the common stockholders. The common stockholders would certainly be no worse off had the merger not occurred.

Taking, as I must, the well-pleaded facts in the Complaint in the light most favorable to plaintiff, it is reasonable to infer that the common stockholders would have been able to receive some consideration for their Trados shares at some point in the future had the merger not occurred. This inference is supported by plaintiff's allegations that the Company's performance had significantly improved and that the Company had secured additional capital through debt financing. Thus, it is reasonable to infer from the factual allegations in the Complaint that the interests of the preferred and common stockholders were not aligned with respect to the decision to pursue a transaction that would trigger the liquidation preference of the preferred and result in no consideration for the common stockholders.

Generally, the rights and preferences of preferred stock are contractual in nature. This Court has held that directors owe fiduciary duties to preferred stockholders as well as common stockholders where the right claimed by the preferred "is not to a preference as against the common stock but rather a right shared equally with the common." Where this is not the case, however, ''generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock-as the good faith judgment of the board sees them to be-to the interests created by the special rights, preferences, *etc.,* of preferred stock, where there is a conflict.'' Thus, in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders. [*Blackmore Partners, L.P. v. Link Energy LLC,* 864 A.2d 80, 85–86 (Del.Ch.2004).] As explained above, the factual allegations in the Complaint support a reasonable inference that the interests of the preferred and common stockholders diverged with respect to the decision of whether to pursue the merger. Given this reasonable inference, plaintiff can avoid dismissal if the Complaint contains well-pleaded facts that demonstrate that the director defendants were interested or lacked independence with respect to this decision.

1. *The Director Defendants' Approval of the Merger*

Plaintiff has alleged facts that support a reasonable inference that Scanlan, Stone, Gandhi, and Prang, the four board designees of preferred stockholders, were interested in the decision to pursue the merger with SDL, which had the effect of triggering the large liquidation preference of the preferred stockholders and resulted in no consideration to the common stockholders for their common shares. Each of these four directors was designated to the Trados board by a holder of a significant number of preferred shares. While this, alone, may not be enough to rebut the presumption of the business judgment rule, plaintiff has alleged more. Plaintiff has alleged that Scanlan, Stone, Gandhi, and Prang each had an ownership or employment relationship with an entity that owned Trados preferred stock. Scanlan was a partner in Wachovia; Stone was a director, employee and part owner of Hg; Gandhi was a partner in several entities referred to as Sequoia; and Prang owned Mentor Capital. Plaintiff further alleges that each of these directors was dependent on the preferred stockholders for their livelihood. As detailed above, each of these entities owned a significant number of Trados' preferred shares, and together these entities owned approximately 51% of Trados' outstanding preferred stock. The allegations of the ownership and other relationships of each of Scanlan, Stone, Gandhi, and Prang to preferred stockholders, combined with the fact that each was a board designee of one of these entities, is sufficient, under the plaintiff-friendly pleading standard on a motion to dismiss, to rebut the business judgment presumption with respect to the decision to approve the merger with SDL.

* * *

Defendants * * * rely on *Orban v. Field,* [1997 WL 153831 (Del.Ch. Apr.1, 1997),] but that decision does not counsel in favor of dismissal at this stage of the litigation. In *Orban,* the Court was evaluating whether a board breached its duties where it ''deploy [ed] corporate power against its own shareholders'' by ''eliminating the leverage of the common stockholders by diluting their ownership interest below 10%'' in order to prevent the common stockholder from using his ability to block a transaction to extract value for his shares. The Court, in deciding to grant summary judgment in favor of defendants, asked whether defendants had met their burden ''to show that their conduct was taken in good faith pursuit of valid ends and was reasonable in the circumstances.'' Although this inquiry was ''inevitably one that must be applied in the rich particularity of context,'' the Court was still able to conclude, based on the evidence in the record, that the plaintiff's ''threat to impede the realization of th[e] transaction by the corporation was thwarted by legally permissible action that was measured and appropriate in the circumstances.'' In making this determination, the Court assumed that the business judgment rule did not apply to the challenged actions.

Here, in contrast, the issue on the motion to dismiss is whether plaintiff has rebutted the presumption of the business judgment rule. Unlike on a motion for summary judgment, I must accept the well-pleaded factual allegations in the Complaint as true. As explained above, those allegations, with the benefit of reasonable inferences, are sufficient, at this stage, to rebut the presumption of the business judgment rule. Unlike in *Orban,* I am unable, at this stage, to make determinations based on the record, such as that the board acted ''both in good faith and reasonably.'' Those determinations must wait for another day.

Plaintiff has alleged facts that support a reasonable inference that a majority of the board was interested or lacked independence with respect to the decision to approve the merger. Accordingly, plaintiff has alleged sufficient facts to survive defendants' motion to dismiss the fiduciary duty claims based on the board's decision to approve the merger.

NOTE: THE DUTY TO THE COMMON WHEN THE COMMON IS UNDER WATER

Trados is the third case in a series. Does it follow or veer from the path set by the precedent?

1. *Orban v. Field.*

Orban v. Field, 1997 WL 153831 (Del.Ch.), involves a contest between the preferred and the common respecting the division of the proceeds of sale of a poorly performing preferred stock issuer.

Before the events in question in the case, the issuer, Office Mart, had three series of stock outstanding. The series and voting rights (each share carried one vote) were distributed as follows: Series A convertible preferred (23 percent), Series B convertible preferred (63 percent), and common (14 percent). The preferred was held by a small number of institutional investors. The overwhelming majority of the common was held by the plaintiff, Orban. Orban had served as the company's promoter at its start up in 1987 and purchased his stock at that time for $15,000. The Series A preferred was initially issued at start up for $2.95 million. The Series B was initially issued in 1988 for $17.08 million.

Office Mart proved to be chronically short of capital. In 1990, the company met this need by offering to its shareholders on a pro rata basis a package of three year secured notes and common stock purchase warrants carrying a right to acquire 40 percent of its fully diluted equity. A group of Series B holders accepted this offer and became creditors of the company. But their notes quickly fell into arrears and in 1991 more warrants were issued to the noteholders in exchange for a deferral of interest payments.

A more elaborate recapitalization followed later in 1991. Pursuant to this, the notes were canceled and replaced by a combination of new Series C nonconvertible preferred and common stock (2.1 million shares constituting more than 50 percent of the outstanding common stock), along with a reduction of the exercise price of the existing common stock purchase warrants. As a result of this, the pre-recapitalization common had its percentage ownership reduced from 14 percent to 3 percent (leaving Orban with 2.54 percent of the votes), and the Series A and Series B preferred had their percentages reduced to 10.5 percent and 36.9 percent.

The 1991 recapitalization ran into a technical snag. Office Mart did not have a large enough number of authorized shares in its charter to support the issue of the new shares and to provide a reserve of shares for the ownership rights created by the new convertible preferred and warrants. The board decided to forego the expense of a charter amendment and instead to do a proportionate reduction in the number of shares outstanding. Orban subsequently was asked to surrender certificates for 874,708 shares. Orban failed to return these certificates, however.

Office Mart's ongoing search for capital next led to acquisition negotiations. A stock-for-stock merger into Staples, Inc. structured as a tax free pooling of interests was announced early in 1992. The merger consideration was 1.093 million shares of Staples common worth around $35 million. The Staples common was to be distributed to the Series A, B, and C preferred in accordance with their preferences. Since the preferences exhausted the consideration, the common would receive nothing. For tax purposes, the merger agreement required the approval of 90 percent of each class of stock. Orban's unreturned certificates created a problem at this point. He had no incentive to vote in favor of the merger but literally could be deemed to hold more than 10 percent of the outstanding common. Orban seized the moment and demanded $4 million in exchange for the certificates. The board refused, and instead engineered the exercise of a sufficient number of existing warrants to dilute Orban's holding to under 10 percent. This was achieved by means of (a) a charter amendment increasing the authorized shares, (b) exercise price reductions respecting the warrants, and (c) a non pro rata redemption of Series C preferred. The Series C redemption siphoned $3 million to the warrant holders to provide them with the cash exercise price. The cash thus came right back to the company when the warrants were exercised.

The result, when the shooting stopped, was that the entire merger consideration went to those who, prior to the recapitalization, had held Series A and B preferred and notes and the simultaneous approval of the merger by 90 percent of the common stock. Significantly, however, the recapitalization had no effect on the distribution of the merger proceeds—assuming respect for preferences, the common would have had no merger proceeds had the recapitalization never occurred.

The theory of Orban's subsequent lawsuit was that, even though the common stock was under water, Orban's stock had a value because of the requirement of a 90 percent vote, and that the destruction of that value by the board's dilutive maneuvering amounted to a breach of fiduciary duty to the common. On motion for summary judgment, Chancellor Allen ruled for the defendants, reasoning as follows:

"For purposes of this motion for summary judgment, I will assume that the business judgment rule is not applicable to the actions challenged by Mr. Orban's breach of fiduciary duty claim. Unquestionably in this instance the board of directors exercised corporate power—most pointedly in authorizing a non-pro-rata redemption of preferred shares for the purpose of funding the exercise by holders of preferred stock of warrants to buy common stock. That act was directed against the common stock who found themselves with a certain leverage because of the requirements for pooling treatment. A board may certainly deploy corporate power against its own shareholders in some circumstances—the greater good justifying the action—but when it does, it should be required to demonstrate that it acted both in good faith and reasonably. * * *

"* * * [I]t is important to note that there is no evidence, or even remaining allegation, that the November recapitalization was part of a scheme to deprive the common stockholders of consideration in the subsequent merger. The recapitalization was legally effectuated by the Board, validly altering the existing ownership structure of the company.[25] Certainly, when viewed as an isolated event, the recapitalization [was] authorized appropriately, and if it were to be tested under a fairness test, it would satisfy that standard. * * *

"Once Orban attempted to use a potential power to deprive the transaction of pooling treatment, the Board was inevitably forced to decide whether it would support the common stock's (Mr. Orban's) effort to extract value from the preferred position or whether it would seek to accomplish the negotiated transaction, which it believed to be the transaction at the highest available price.

"Certainly in some circumstances a board may elect (subject to the corporation's answering in contract damages) to repudiate a contractual obligation where to do so provides a net benefit to the corporation. * * * But it would be bizarre to take this fact of legal life so far as to assert, as Mr. Orban must, that the Board had a duty to common stock to refrain from recognizing the corporation's legal obligations to its other classes of voting securities.

"To resolve this situation, the Board decided not to negotiate with Mr. Orban, but rather to effectuate the transaction as intended, respecting the preferential rights of the preferred stockholders. In my opinion, it cannot be said that the Board breached a duty of loyalty in making this decision. Whereas the preferred stockholders had existing legal preferences, the common stockholders had no legal right to a portion of the merger consideration under Delaware law or the corporate charter. The Staples' transaction appeared reasonably to be the best available transaction. Mr. Orban's threat to impede the realization of that transaction by the corporation was thwarted by legally permissible action that was measured and appropriate in the circumstances. * * *"

Questions: Were there any contract rights to the preferred that would have been breached by an allocation to the common? Does the court assert that the preferred had a *right* to have its liquidation preference satisfied first out of the proceeds of the merger? If the charter did not provide explicitly that a merger should be treated as a liquidating event, would not the board have had the option of allocating some of the merger consideration to the common?

2. *Blackmore Partners v. Link Energy.*

Blackmore Partners, L.P. v. Link Energy LLC, 864 A.2d 80 (Del.Ch.2004), is the second case in the series.

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25. The recapitalization was approved by Mr. Orban as a director and ratified by a majority of Office Mart's shareholders. As was discussed above, this Court has already determined that Mr. Orban had no legal right to a class vote on the recapitalization. Ordinarily, the approval of disinterested directors and shareholder ratification would provide the recapitalization with the protection of the business judgment rule.

Link Energy LLC emerged from the Chapter 11 restructuring of EOTT Energy Partners LP. In the reorganization, a class of unsecured 11 percent noteholders with a $235 million claim received a new issue of 9 percent notes with a face value of $104 million and a pro rata share of Link Energy equity units; EOTT common received 3 percent of Link Energy's equity units; the rest of the Link Energy Equity units were distributed to its other unsecured creditors.

Link's performance upon emergence from the Chapter disappointed its managers. They announced that they were considering alternatives to continuing operation and engaged Lehman Brothers Inc. as an advisor. Link soon thereafter agreed to sell its assets and business to Plains All American Pipeline, L.P. for $290 million. Under the terms of the Link LLC operating agreement the board of directors had the power to effectuate that transaction without a vote of unit holders. Link thereafter duly sold substantially all of its assets, ceased all of its principal business, and proceeded to wind up.

Prior to the asset sale, Link issued a press release disclosing the negotiations and stating that any proceeds of sale would be used to pay its creditors. As to the equity units, the release stated: ''Based on current projections, the company's management believes that its unit holders would receive a minimal amount, if any, after payment of, or otherwise making provision for, all of its liabilities, obligations and contingencies, which are substantial. There can be no assurance, however, that there will be any funds to distribute to unit holders.'' The press release also stated that ''[t]his sale is in Link Energy's long-term best interest in order to protect the value of the assets, the needs of our customers, and the jobs of our employees.''

The market responded quickly: the next day price of the equity units dropped from $5 to $1. They went on down to $0.20 before trading was halted. Unit holders, including the plaintiff, promptly contacted management about the possibility of ''alternate transactions.'' But management closed on the asset sale within a few weeks. Of the $290 million proceeds, $265 million was used repay debt, including the 9 percent notes. In addition to the value of the principal and the accrued interest, the 9 percent note holders also received their pro rata share of the $25 million remaining from the sale of Link's assets. This $25 million kicker was described as consideration for the note holders waiving covenants in the notes that required any purchaser of Link's assets to assume the notes.

The complaint alleged that the Link board members violated fiduciary duties owed to the equity holders by approving the sale of substantially all of Link's assets to Plains. Two distinct, but related, claims were raised. First, the complaint alleged that the board favored the 9 percent note holders (to whom it did not owe a fiduciary duty) by approving the distribution to them of the $25 million excess consideration at the expense of the unit holders,. Second, the complaint alleged that the board failed to maximize unit holder value in a sale of control transaction and, therefore, violated its duty of loyalty under *Revlon*.

Affirming the Chancery Court's denial of the defendants' motion to dismiss, the Delaware Supreme Court reasoned as follows, 864 A.2d at 85–86:

''Once a board of directors determines to sell the corporation in a change of control transaction, its responsibility is to endeavor to secure the highest value reasonably attainable for the stockholders. * * * [T]he board's actions must be evaluated in light of the relevant circumstances to determine whether they were undertaken with due diligence and in good faith. If no breach of duty is found, the board's actions are entitled to the protections of the business judgment rule. * * *

''The complaint alleges, and for purposes of this motion the court assumes as true, that the Director Defendants approved a transaction that disadvantaged the holders of Link's equity units. Until the announcement of the transaction, the units had significant, if not substantial, trading value. Indeed, there is a basis in the complaint to infer that the value of Link's assets exceeded its liabilities by least $25 million. Moreover, the facts alleged support an inference that Link was neither insolvent nor on the verge of re-entering bankruptcy. Yet, as a result of the transaction at issue, those units were rendered valueless.

''In the circumstances, the allegation that the Defendant Directors approved a sale of substantially all of Link's assets and a resultant distribution of proceeds that went exclusively to the company's creditors raises a reasonable inference of disloyalty or intentional misconduct. * * * [B]ased only the facts alleged and the reasonable inferences that the court must draw from them, it would appear that no transaction could have been worse for the unit holders and reasonable to infer, as the plaintiff argues, that a properly motivated board of directors would not have agreed to a proposal that wiped out the value of the common equity and surrendered all of that value to the company's creditors.

''In an analogous case, Chancellor Allen recognized '[t]he broad principle that if directors take action directed against a class of securities they should be required to justify' their action. [Orban v. Field, 1993 WL 547187, at *9 (Del.Ch. 1993).] Thus, while on a more complete record, it may appear that the Director Defendants took no such action or were justified in acting as they did, this court cannot now conclude that the complaint does not state a claim for breach of the duty of loyalty * * *.''

In **Blackmore Partners, L.P. v. Link Energy LLC**, 2005 WL 2709639 (Del.Ch.), the Chancery Court later granted the defendants' motion for summary judgment, having found as a fact that Link was insolvent during the events in question. The plaintiff's theory was treated as follows:

''The plaintiff claims that Chancellor Allen's decision in Orban v. Field requires 'that when a board approves a transaction that favors one corporate constituency over another, they lose, at least as an initial matter, the cloak of business judgment protection.' But the plaintiff's reliance on Orban for the proposition that the company owed the Unit holders a higher duty of care in this case is misplaced.

''It is doubtless true, as Chancellor Allen noted in Orban, that a board deploying corporate power against a class of shareholders must specially demonstrate that it acted reasonably and in good faith. But that duty, though important, is limited to circumstances where the board uses the very levers of corporate power against its own shareholders in order to achieve some purportedly higher end. In Orban itself, for example, the board did not simply make a business decision that hurt shareholders while repaying creditors, but engaged in an elaborate maneuver in which the defendant company intentionally diluted a major shareholder to a position where he was powerless to stop a merger favored by the directors. In the face of such overwhelming force, it was clearly appropriate for the court to require the board to demonstrate the reasonableness and good faith of its action on a full evidentiary record. And even in that case, the court eventually upheld the board's action as necessary in otherwise pressing circumstances.

''This case stands in sharp contrast to Orban. The corporate action complained of here, though it did result in Unit holders being left with no residual value, did not involve the use of corporate power against a shareholder class in the sense of Orban. The defendants did not act 'solely or primarily for the express purpose of depriving a shareholder of effective enjoyment of a right conferred by law.' Crucially, the Unit holders, by charter, did not even retain the right to vote on the sale of substantially all of Link's assets. Thus, no extraordinary efforts were needed to secure approval, or to stop a vote, for no such approval or vote was necessary. In