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Fiduciary Risks for Venture Directors in Financings and Sales

A dilutive financing or low value sale has the potential to attract unwanted legal attention for venture directors.

Two recent decisions by the Delaware Court of Chancery highlight the risks of certain types of financing and sale transactions at companies where venture capital investors control the board of directors. These cases dealt with two of the biggest challenges that venture directors can face at a portfolio company: *Trados* concerned a sale of the company for less than the liquidation preferences; and *Bloodhound* addressed the problem of a dilutive financing by inside investors.

Both cases serve as a warning – to venture-backed companies generally and to venture directors specifically – about the right way and the wrong way to proceed in transactions that have the potential to financially impact the interests of holders of common stock and other junior securities.

We have prepared a summary of the two cases, discuss the implications for venture directors, and conclude with some best practices, including an explanation of how a fairness opinion (an independent valuation) can assist a company and its directors in similar situations.

Trados: Sale for Less Than the Liquidation Preferences

In August 2013, the Court of Chancery issued its final judgment for *In Re Trados Shareholder Litigation.*[1] The court decided that the venture-controlled board of directors failed to run a sale process which was fair to the common stockholders; however, the court saved the defendants from financial liability by also finding that the common stock was worthless at the time of the sale.

The final judgment followed a lengthy and costly trial, a trial which proceeded because the defendant directors' motions to dismiss were denied when the court found that the venture-controlled board could not rely on the business judgment rule to defend a sale of the company.[2] The failure of the motions to dismiss in 2009 so alarmed the venture capital community that the National Venture Capital Association modified its model form documents in response.[3]

Claims

After the sale was completed, a former employee who held approximately 5% of the common stock of Trados filed two suits, first seeking an appraisal of the value of his shares and later alleging breach of fiduciary duty by the board of directors. The suits eventually were consolidated.

The claim for breach of fiduciary duty alleged that the directors had voted to sell the company at a time when it was growing and profitable and, by doing so, the directors unfairly favored the interests of the holders of preferred stock over the interests of the holders of common stock. It was claimed that the holders of common stock lost the opportunity to share in the proceeds of a sale of the company for a higher value at a later date.

Summary Judgment

The defendant directors moved to dismiss the suit, arguing that the business judgment rule protected their decisions. Generally, the Delaware courts are sympathetic to invocations of the business judgment rule and give directors wide latitude in exercising their business judgment. But, when a majority of the directors is interested in a transaction, the standard shifts from the business judgment rule to the entire fairness standard. (More on this below in “Final Judgment, Entire Fairness.”)

Background to *Trados*

Trados was founded in 1984 and developed proprietary desktop computer software for language translation. By the late 1990s, the company had a dominant position in the desktop translation market and decided to expand into the enterprise market. To do this, Trados sought venture capital funding and acquired another company in the same market. Between 2000 and 2003 Trados took on several series of preferred stock, most of it participating with a cumulative 8% dividend.

There was some growth in the business during this period, but it came with large operating losses. In 2004, the company replaced its CEO, cut operating expenses, and refocused its sales strategy in an effort to stem the cash outflow. Trados sought additional equity, but neither new nor existing investors were willing to provide it. Some of the company’s investors advocated that Trados be sold, an investment bank was hired, and a management incentive plan (MIP) was put in place to motivate management in a sale process.

In 2005, Trados was sold to SDL plc for approximately $60 million in cash and stock (after Trados declined an offer of $40 million from SDL in 2004). The MIP paid $7.8 million to management and the remaining $52.2 million went to the holders of preferred stock,[4] in partial satisfaction of their claims for liquidation preferences and accumulated dividends totaling $57.9 million. The holders of common stock received nothing (although they would have received a portion of $2.1 million if there had not been a MIP)

In any motion by the defendants to dismiss a suit, the court is obligated to assume that facts alleged by the plaintiff are true.[5] The plaintiff alleged that: (a) a majority of the board of directors of Trados was appointed by the holders of preferred stock (these directors were affiliated with entities owning the preferred stock and/or owned preferred stock themselves); (b) the preferred stock received substantially all of the proceeds from the sale of the company; and (c) the preferred stockholders had wanted to sell the company in order to exit their investments at a time when the common stockholders did not want to sell.

Based on these allegations, the court concluded that it was possible that a majority of the members of the board of directors had been unable to exercise independent and disinterested business judgment in deciding whether to sell the company and in agreeing to the terms of the sale; "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."[6]

Accordingly, the court refused the motion to dismiss and the defendants were forced into a costly four year cycle of pleadings, discovery, depositions, expert reports, and eventually a multi-week trial.

Final Judgment

After a review of the facts and the claims, the Court of Chancery began its opinion in the final judgment by emphasizing that there is a difference between the "[s]tandard of conduct, [which] describes what directors are expected to do … and the standard of review, [which] is the test the court applies when evaluating whether the directors have met the standard of conduct."[7]

Standard of Conduct

With this distinction in mind, the court explained the two primary fiduciary duties of the directors: a duty of loyalty; and a duty of care. The duty of loyalty was defined as making decisions designed to "maximize the value of the company over the long-term for the benefit of the providers of equity capital."[8]

The rights of the preferred stock were examined and the court determined that a "board does not owe fiduciary duties to preferred stockholders when considering whether or not to take corporate action that might trigger or circumvent the preferred stockholders' contractual rights."[9] Significantly, the court affirmed that it is "'the duty of the board ,,, to prefer the interests of the common stock … to the interests created by the special rights, preferences, etc. … of preferred stock.'"[10]

Standard of Review

The court next laid out the three main standards of review: business judgment, enhanced scrutiny, and entire fairness.

The default standard in Delaware is the business judgment rule.[11] Unless some part of the rule is rebutted by evidence, a court's review of it is "merely to see whether the business decision made was rational in the sense of being one logical approach to advance the corporation's objectives."[12]

Enhanced scrutiny is an intermediate standard and it "applies to specific, recurring, and readily identifiable situations involving potential conflicts of interest where the realities of the decisionmaking context can subtly undermine the decisions of even independent and disinterested directors."[13] The Delaware courts applied enhanced scrutiny in the well-known *Unocal* and *Revlon* cases and more recently in the *El Paso* case.[14]

The most onerous standard is entire fairness and it applies when the members of a board of directors have actual conflicts of interest. "Once entire fairness applies, the defendants must establish 'to the court's satisfaction that the transaction was the product of both fair dealing and fair price.'"[15] If the plaintiff can prove that there were not enough independent and disinterested directors to comprise a majority of the board making the challenged decision, then the business judgment rule cannot be used.[16]

Review of Directors

In *Trados* the Court of Chancery conducted a director-by-director review. It concluded that six of the seven directors were not disinterested and independent: (a) the three venture directors all were found to be interested because they and/or their firms owned preferred stock (making them "dual fiduciaries"[17]); (b) the two management directors both were found to be interested because of their employment and because they received substantial payments from the MIP; and (c) even one of the "so-called 'independent directors'" was found to be interested because of his prior involvement with one of the venture capital funds and his ownership of preferred stock of Trados.[18] As a consequence, the entire fairness standard was applied.

Entire Fairness

Entire fairness is a two-pronged test: fair process and fair price.[19] Each prong is considered separately, but the decision is determined as a whole.[20]

The court examined the evidence related to fair dealing and found that the board of

directors of Trados had not conducted a fair process. The factors which showed a lack of fairness included: the manner in which the sale process was initiated (by the venture directors holding preferred stock), the creation of the MIP (which "took value away from the common"[21]), the board approval (which did not consider the effect of the sale on holders of common stock and did not consider forming a special committee or obtaining a fairness opinion[22]), and the stockholder approval (which did not seek a vote of the majority of the disinterested shareholders[23]).

Despite the lack of a fair process, the defendant directors were saved from financial liability by the court's parallel finding that the outcome resulted in a fair price (zero) to the holders of common stock. There was conflicting testimony about the financial condition of Trados before the sale, with the plaintiff highlighting reports by the incoming management team about increasing revenues and the defendants pointing to persistent losses and lack of cash. The court considered the value placed on the common stock of Trados by the board for the purposes of granting stock options[24] and information from the investment banking firm's presentations about potential buyers, but in the end relied on the work of the valuation experts to determine the fair value of Trados and shares of common stock at the time of the sale to SDL.

The Delaware Supreme Court has stated that the proper test for fairness is whether "'the minority stockholder shall receive the substantial equivalent in value of what he had before.'"[25] In its value conclusion, the Chancery Court became convinced that "Trados likely could self-fund, avoid bankruptcy, and continue operating, but it did not have a realistic chance of generating a sufficient return to escape the gravitational pull of the large liquidation preference and the cumulative dividend."[26] So, in the end, the court determined that the value of the Trados common stock was zero and, accordingly, that the transaction was entirely fair.[27]

Implications for Venture Directors

The decision in *Trados* did not result in a damage award against the defendant directors because their actions did not result in harm measured against the second prong of the entire fairness standard: fair price. Nonetheless, the opinion is significant to venture directors for several reasons having to do with the first prong of the entire fairness standard: fair process.

The opinion stated that venture directors are *prima facie* conflicted on decisions involving sales which benefit the preferred stock held by their venture capital firms and manager directors are *prima facie* conflicted because of their employment and/

or participation in a MIP. The opinion cast doubt on the overall fairness of a MIP. And the opinion cataloged the protective measures which the directors failed to employ: the court observed in a footnote that employment of even one such measure, formation of a special committee, “could well have resulted in business judgment deference” (meaning that the defendants likely could have prevailed at the summary judgment stage and avoided a costly trial).[28]

Bloodhound: Dilutive Financing by Inside Investors

In March 2013, the Court of Chancery issued an opinion in *Carsanaro v. Bloodhound Technologies.* [29] The decision allowed a group of founders to proceed with a lawsuit alleging that they were damaged by the actions of the venture-controlled board of directors which authorized several preferred stock transactions that diluted the ownership of the founders to nearly nothing.

Claims

Breach of Fiduciary Duty – Dilutive Financings

The plaintiffs claimed that the members of the board of directors breached their fiduciary duties in approving a series of dilutive financings. Unlike in previous financings, the company did not approach new outside investors, but instead issued all of the preferred stock to existing investors and their principals. At the same time as the preferred stock transactions, the board of directors approved grants of common stock to management of the company, including some managers who also sat on the board.

The defendants moved to dismiss the plaintiffs’ claim, citing the business judgment rule. The Chancery Court rejected this, noting that the board of directors had a majority of interested directors; the venture directors were interested because they worked for the venture capital funds which purchased the preferred stock and the manager directors were interested because they were given grants of common stock in connection with the financings.

Breach of Fiduciary Duty – MIP

The plaintiffs also claimed the members of the board of directors breached their fiduciary duties in approving the sale and the creation of a MIP. Again the defendants pleaded the business judgment rule and again the Chancery Court determined that it was not available because the board of directors did not include a sufficient number of

independent and disinterested directors.

In a trial, it will be up to the defendants to prove that the acquisition was entirely fair. This may be difficult because the Chancery Court opined that diversion of nearly 19% of the acquisition "consideration to the MIP support[ed] a reasonable inference that the merger was unfair."[30]

Improper Stockholder Approval – Series E Financing

Finally, the plaintiffs also argued that the approval of the "cram-down" Series E financing was not properly approved by both the board of directors and a majority of shareholders, as required by §242 of Delaware General Corporation Law (DGCL).

The Chancery Court found that there was not proper notice of the financing because the common stockholders were not given all of the necessary documents.

Implications for Venture Directors

The decision in *Bloodhound* was only a summary judgment, so there was no finding of liability or damage award. Nonetheless, it is significant to venture directors for several reasons. The opinion granted standing to individual plaintiffs (previously individual shareholders could file only derivative claims and those were extinguished on closing of an acquisition). The opinion

Background to *Bloodhound*

Carsanaro founded Bloodhound Technologies in 1998 to create web-based software that would help healthcare providers detect fraud. He and four other founders (the Founders) raised five series of preferred stock from venture capital investors for a total of $15 million. The per share price moved up and down in these financings, but then it fell dramatically between the Series D and Series E rounds. The Founders, including Carsanaro, left the company at various points and Carsanaro and another founder left the board of directors, all at the suggestion of the venture capital investors.

The venture capital investors then expanded the size of the board of directors and gained a majority of its members, which they used to issue several additional rounds of Series E to their firms and other related parties at the same low value – despite steady improvement in the company's financial performance. Eventually, Bloodhound Technologies was sold to Verisk Health for $82.5 million in April 2011. At that time, the board of directors created a MIP granting senior members of management approximately $15 million, an amount which was subtracted from the acquisition consideration.

By the time that the company was sold, common stock comprised 2.2% of the capitalization; the Founders owned less than 1.0%. Because of the liquidation preferences of the preferred stock and the MIP, the Founders received less than $36,000 from the sale; one founder received $99.

reinforced the position in *Trados* that venture directors are *prima facie* conflicted on decisions involving financing from their venture capital firms and manager directors are *prima facie* conflicted when they receive equity grants after such financings. The opinion cast substantial doubt on the fairness of a MIP. And the opinion forced the defendants into a trial process which is likely to be long and costly.[31]

In the future, it is possible that buyers of companies which have been through dilutive venture capital financings will be wary of taking on potential liability. Already there is talk among merger and acquisition professionals that buyers may negotiate limits to the survival of post-closing indemnification to exclude actions taken by directors in connection with these types of financings earlier in the life of the company being purchased.

Summary: Best Practices and Fairness

Many venture-backed companies have a board of directors which is dominated by representatives from venture capital firms. The Court of Chancery in both *Trados* and *Bloodhound* was quick to determine that these directors were interested in a transaction which benefited their venture capital firms – whether a dilutive financing or a sale for less than the amount of the liquidation preferences.

Likewise, in these two decisions, the Court of Chancery determined that company managers who sat on the boards of directors and who benefited from these sorts of transactions – whether by grants of new equity incentives or by participation in a MIP – also were interested in the transactions.[32] Even outsiders who appeared to be independent directors were not regarded by the court as truly disinterested because of the web of relationships in Silicon Valley and other technology communities.[33]

Once a plaintiff establishes that conflicts of interest existed among the directors who approved a transaction and that there were no procedural safeguards in place (such as those described in “Best Practices,” below), then the defendants take on the burden of proving that the transaction was objectively the product of fair dealing and resulted in a fair price.[34]

When there is not a majority of disinterested directors (or a special committee), then the board of directors should be aware that the business judgment rule likely will not be available and that it may have to meet the entire fairness standard. Accordingly, it becomes all the more important to satisfy the two-pronged test of entire fairness.

Best Practices

There are certain steps to consider taking when a board is about to sell a company for less than the liquidation preferences or when it is about to subject a company to a dilutive financing. In a perfect world, it would be possible to obtain approval of both a majority of disinterested directors and a majority of disinterested shareholders.[35] However, the world is not perfect and that sometimes is not possible. Nonetheless, a company should attempt to utilize as many of these best practices as possible.

- Show the transaction (whether a sale or a financing) to other potentially interested parties and document the activity.
- Hold more than one board meeting to consider the transaction and include in the minutes an analysis of alternatives (whether a sale or a financing) and an analysis of the impact of the transaction on junior securities (common stock and even junior series of preferred stock).
- Review the terms and effects of recent financings, equity grants, and valuations (including stock option pricing and IRC 409A valuation reports[36]).
- Form a special committee of disinterested directors and empower it to hire independent advisors (legal and valuation), to negotiate the terms of the transaction, and to provide final approval of the transaction.
- Obtain a vote of a majority of the disinterested shareholders (often called a "majority of the minority") in favor of the transaction, after providing complete information.
- In a dilutive financing, allow pro rata participation by all shareholders.
- In a sale for less than the preferences, provide a carve out of part of the sale proceeds to benefit holders of common stock and junior series of preferred stock.
- Obtain a fairness opinion to support the valuation on which the transaction is based.

If the transaction is later challenged and the standard of review is entire fairness, obtaining a fairness opinion works toward proving both fair dealing and fair price. The fact that the directors sought independent validation of the value of the transaction is part of the process of showing that they conducted a fair process. And the valuation work underlying a fairness opinion supports the determination of fair price.

Why Should You Obtain a Fairness Opinion?

There are two primary reasons why a company and members of its board of directors should consider a fairness opinion in connection with certain types of financing or sale transactions.[37]

First, Delaware statute law explicitly provides that a director relying in good faith on expert advice is "fully protected" from liability.[38] If a fairness opinion is appropriately sought and reasonably relied upon, it can be instrumental in supporting a motion to dismiss by defendant directors.[39] And, even if the case is not dismissed and goes to trial, the Delaware courts have cited fairness opinions as a reason to absolve directors from liability under §141(e) of DGCL.[40]

Second, Delaware common law frequently looks to whether the directors sought a fairness opinion during a review of a transaction under the entire fairness standard. In multiple cases when the decision making process of a board of directors was challenged, the Delaware courts have noted that a fairness opinion was obtained.[41] In the other direction, the Delaware Supreme Court has cited the lack of a fairness opinion or other independent valuation when it held that a board of directors breached its duty of care in a change in control transaction.[42]

When Should You Obtain a Fairness Opinion?

When a company is sold for a nominal amount and the proceeds are only enough to pay off debts and transaction expenses, it is unlikely that common stockholders will pursue legal action against the board of directors. (Frankly, there is not enough money at stake to hold the attention of plaintiffs' attorneys.) And when a company is sold for a large amount and the proceeds are more than enough to pay off the liquidation preferences – or better yet, are large enough to motivate the preferred stockholders to convert to common stock – it also is unlikely that common stockholders will pursue legal action against the board of directors.

Thus, it is a company sale value which lies between these two extremes which has the potential to attract unwanted legal attention.

In the same vein, when a company experiences financial difficulty, goes through a dilutive financing – whether a severe cram down or merely an inside down round – and eventually sells for very little, it is unlikely that common stockholders will pursue

legal action against the board of directors. (Again, there is not enough money at stake to hold the attention of plaintiffs' attorneys.)

But, on the other hand, if that company eventually is sold for a large amount, then it has the potential to attract unwanted legal attention.

A fairness opinion is not just window dressing. At its most fundamental level, a fairness opinion provides valuation information and decision support to a board of directors when reliable market-based price information is unavailable. A privately-held company considering a difficult transaction – especially a sale of a company for less than the preferences or a dilutive financing – should consider obtaining a fairness opinion. And it should do so before negotiating all of the terms of the transaction.

Year in and year out, many of the fairness opinions provided by Teknos have pertained to these two situations: the fairness of a sale of a company for a value which is close to the liquidation preferences; and the fairness of a dilutive financing by existing investors. Please contact us if you would like to discuss whether your company could benefit from our expertise and services.

Teknos Associates provides valuation services for emerging growth companies and their venture capital backers. Clients rely on our financial expertise, knowledge of technology markets, and high standards to deliver relevant and timely valuation reports and fairness opinions.

Engagement Disclaimer: *Teknos Associates provided expert witness testimony in connection with the* Trados *case. However, our comments on the case are based only on information which is in the public record and the opinions in this whitepaper are those only of Teknos Associates and may not be taken to represent the position of any of the litigants or law firms involved in the case.*

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1. *In Re Trados Incorporated Shareholder Litigation (Trados II)*, C.A. No. 1512-VCL (Del. Ch. Aug. 16, 2013). Available at http://courts.delaware.gov/opinions/download.aspx?ID=193520

2. *In Re Trados Incorporated Shareholder Litigation (Trados I)*, C.A. No. 1512-CC (Del. Ch. July 24, 2009). http://courts.delaware.gov/opinions/download.aspx?ID=124840

3. See "Certificate of Incorporation," p. 33, fn. 60 and "Voting Agreement," p. 6, fn. 12 and Addendum to Voting Agreement: Sample Sale Rights, fn. 29; both on the website for the National Venture Capital Association at http://www.nvca.org/index.php?option=com_content&view=article&id=108:model-legal-documents&catid=43:resources&Itemid=136

4. Ignoring the effects of any claims against the escrow and any potential for change in the value of the stock portion of the consideration.

5. *Trados I, pp. 10-11.* "The Court may grant a motion to dismiss for failure to state a claim … if the Court can determine with reasonable certainty that the plaintiff would not be entitled to relief under any set of facts that could be reasonably inferred from the well-pleaded allegations in the complaint. In considering a motion to dismiss, the court must accept the well-pleaded allegations of fact in the complaint as true and draw all reasonable inferences that logically flow from those allegations in the plaintiff's favor."

6. *Trados I*, pp. 19-20. Emphasis in original.

7. *Trados II*, p. 31. The court went on to note that "in every situation, the standard of review is more forgiving of directors and more onerous for stockholder plaintiffs than the standard of conduct." *Trados II*, p. 32.

8. *Trados II*, p. 34.

9. *Trados II*, p. 38. In fn. 8, the court continued that "[t]he primacy of the negotiated contract should not be overstated: preferred stock is senior in defined respects to common, but it is equity, not debt, and it remains subject to the statutory and common law limitations that apply to equity." And the court then quoted from the decision in *Carsanaro v. Bloodhound Technologies Inc. (Bloodhound)*, C.A. No. 7301-VCL (Del. Ch. Mar. 15, 2013), discussed at length, *infra*.

10. *Trados II*, p. 41, quoting *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1042 (Del. Ch. 1997).

11. The "business judgment rule" was outlined by the Delaware Supreme Court in *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1985); "… in making a business decision the directors of the corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."

12. *Trados II*, p. 45, quoting *In Re Dollar Thrifty Shareholder Litigation*, 14 A.3d 573, 598 (De. Ch. 2010).

13. *Trados II*, p. 45.

14. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); and *In Re El Paso Corp. Shareholders Litigation*, 41 A.3d 432 (Del. Ch. 2012).

15. *Trados* II, p. 47, quoting from *Cinerama, Inc. v. Technicolor, Inc. (Technicolor III)*, 663 A.2d 1156, 1163 (Del. 1995). Emphasis in original.

16. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1985), "[if] the transaction is not approved by a majority consisting of the disinterested directors, then the business judgment rule has no application whatsoever."

17. *Trados II*, p. 51, citing *Weinberger v. UOP, Inc. (Weinberger)*, 457 A.2d 701, 710 (Del. 1983).

18. *Trados II*, p. 66, citing Jesse M. Fried and Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups (Agency Costs)*, 81 N.Y.U. L. Rev. 967, 990-93 (2006).

19. *Weinberger*, "The concept of fairness has two aspects: fair dealing and fair price. [Fair dealing] embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors were obtained. [Fair price] relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of the company's stock."

20. *Trados*, pp. 69-70; "Although the two aspects [of fair dealing and fair price] may be examined separately, 'the test for fairness is not a bifurcated one between fair dealing and fair price. All aspects of the issue must be examined as a whole since the question is one of entire fairness,'" quoting from *Weinberger*.

21. *Trados II*, p. 76. The court especially faulted the structure of the MIP, which included a cutback, incentivizing participants to focus on the MIP rather than their equity holdings. "The MIP converted the management team from holders of equity interests aligned with the value of the corporation to claimants whose return profile and incentives closely resembled those of the preferred." *Trados II*, p. 80. Had the board not created the MIP, there would have been $2.1 million of proceeds available for the holders of common stock. In essence, the first $2.1 million to the MIP was funded by the common stockholders and the remaining $5.7 million was funded by the preferred stockholders; the common stockholders paid 100% of their potential proceeds, whereas the preferred stockholders paid about 10% of their potential proceeds. See also *Trados I*, p. 10.

22. *Trados II*, p. 85.

23. *Trados II*, p. 86, "The defendants never considered conditioning the Merger on the vote of a majority of the disinterested common stockholders….The vote on the Merger was delivered by the preferred, who controlled a majority of the Company's voting power on an as-converted basis, and other '[l]arge [f]riendlies.'"

24. In the end, the court accepted the defendant directors' claims that they thought that valuing common stock for the purposes of stock options was "arbitrary" and that they used "rules of thumb," because this was "during an era when stock option backdating was prevalent among Silicon Valley technology companies." *Trados II*, pp. 95-96. Since the implementation of Internal Revenue Code §409A and the reliance of companies upon independent appraisals, this environment has changed.

25. *Trados II*, pp. 107-108, quoting *Sterling v. Mayflower Hotel Corp.,* 93 A.2d 107, 114 (Del. 1952).

26. *Trados II*, p. 110.

27. While the court found no liability for breach of fiduciary duty, the court did agree to hear a request from the plaintiff seeking fees and expenses under the bad faith exception to the American Rule (because of failures by the defendants to produce documents, possibly frivolous motions for summary judgment, and some "less-than-credible trial testimony"). *Trados II*, pp. 112-113.

28. *Trados II*, p. 85, fn. 39, "If a duly empowered and properly advised committee had approved the Merger, it could well have resulted in business judgment deference." Presumably this is different from the situation described by the same judge, Vice Chancellor Laster, when he opined that "the use of a single pro-

cedurally protective mechanism, such as a special committee or majority of the minority vote, does not restore the business judgment rule," *Bloodhound*, p. 64. The difference likely is that he presumed a "controller" in *Bloodhound*, whereas he did not presume a "controller" in *Trados*. See fn. 35, *infra.*

29. *Bloodhound.* Available at http://courts.delaware.gov/opinions/download.aspx?ID=186730

30. *Bloodhound*, p. 29.

31. The case is labeled "Closed" on the Court of Chancery docket, implying that it has been settled by the parties. No details of the settlement have been disclosed.

32. It also is possible that post-transaction employment for managers who serve as directors would have the same effect. See *Trados II* at pp. 49-50 and 51.

33. *Trados II,* p. 66; "Because of the web of interrelationships that characterizes the Silicon Valley startup community, scholars have argued that so-called 'independent directors' on VC-backed startup boards 'are often not truly independent of the VCs.'" Citation from *Agency Costs, op. cit.*, p 988.

34. *Technicolor III*.

35. Delaware Court of Chancery applied the business judgment rule to a going-private transaction in *In Re MFW Shareholder Litigation*, C.A. No. 6566-CS (Del. Ch. May 29, 2013) and granted the controlling defendant's motion to dismiss the suit because the merger was conditioned on both an independent special committee and a vote of the majority of the minority shareholders (it was important that both protections were in place because they mirror the provisions of §251 of the Delaware General Corporate Law approval process). Obviously, many companies cannot exactly replicate these safeguards, hence the discussion of alternative measures.

36. See fn. 24, *supra*.

37. *Bloodhound*, pp. 28-29, "Corporate acts are 'twice-tested,' once for statutory compliance and again in equity." *Sample v. Morgan*, 914 A.2d 647, 672 (Del. Ch. 2007), which in turn quoted from Adolph A. Berle, *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049, 1049 (1931).

38. Delaware Code., tit. 8, ch. 1, subch. IV, §141(e), "Directors are fully protected in relying in good faith … upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees … or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence." Before an amendment which broadened the definition of expert in 1987, the statute read "by an independent certified public accountant, or by an *appraiser* selected with reasonable care." Delaware Laws 422, 423 (1943). Emphasis added. The words "fully protected" are helpful, but should not be taken as complete absolution. An opinion on fairness may help to prove fairness, but a fairness opinion does not substitute for the requirement in §144(a)(3) that a transaction be fair to the corporation. Generally, the Delaware courts have limited §141(e) protection to directors in duty of care cases.

39. *Ash v. McCall*, No. 17132 Del. Ch. (2000). "The complaint here, fairly read, alleges that the McKesson directors were advised by their experts (Deloitte and Bear Stearns) and that they relied on their expertise in conducting due diligence ancillary to the proposed merger. So the question becomes whether such directors are to be 'fully protected' on the basis that they relied in good faith on qualified experts under 8 Del. C. §141(e). The McKesson board is entitled to the presumption that it exercised proper business judgment, including proper reliance on experts. Plaintiffs have not rebutted the presumption with particularized facts creating reason to believe that the McKesson board's conduct was grossly negligent. That is, plaintiffs have not alleged particularized facts (in contrast with conclusions) that, if proved, would show that (1) the directors in fact did not rely on the expert, or (2) that their reliance was not in good faith, or (3) that they did not reasonably believe that the experts' advice was within the experts' professional competence, or (4) that the directors were at fault for not selecting experts with reasonable care, or (5) that the issue (here, alleged accounting deficiencies in HBOC's financial records) was so obvious that the board's failure to detect it was grossly negligent regardless of the experts' advice, or (6) that the board's decision was so unconscionable as to constitute waste or fraud. This complaint is devoid of particularized allegations along these lines and is, therefore, incapable of surviving a motion to dismiss."

40. *Crescent/Mach I Partners, L.P., et al. v. Turner, et al.*, 846 A.2d (Del. Ch. 2000); and *In Re RJR Nabisco, Inc. Shareholders Litigation*, 1989 WL 7036 (Del. Ch. 1989).

41. *In Re Compucom Systems, Inc. Stockholders Litigation*, 2005 WL 2481325 (Del. Ch. 2005); *Angelo, Gordon & Co., L.P. v. Allied Riser Communications Corp.*, 805 A. 2d 221, 229 (Del. Ch. 2002); *Ash v. McCall, supra.*; *Wisconsin Investment Board v. Bartlett*, 2000 WL 238026 (Del. Ch. 2000); and *Dairy Mart Convenience Stores, Inc.*, 1999 WL 350473 (Del. Ch. 1999).

42. *Smith v. Van Gorkom (*sometimes called *TransUnion)*, 488 A.2d 858 (Del. 1985), pp. 877 to 878. The Delaware Supreme Court held that the directors' failure to obtain anything other than an oral estimate of value from the company's chief financial officer did not satisfy their duty of care to inform themselves of the company's value. While the Court said "[w]e do not imply that an outside valuation study is essential to support an informed business judgment; nor do we state that fairness opinions … are required as a matter of law," the Court went on to note that the directors' failure to obtain a valuation report was part of the breach of their duty of care to be informed and, for that reason, they had not established a basis to rely on §141(e). The court in *Trados* also implies that it was a negative that the directors had not sought a fairness opinion. See *Trados II*, pp. 85-86.