MORRIS NICHOLS ARSHT & TUNNELL

# Court of Chancery Finds Breach of Fiduciary Duty in Private Company Recapitalization Based on Inadequate Process, Despite Fair Price

In an opinion issued on September 4, 2014, *In re Nine Systems Corp. Shareholders Litigation*, the Court of Chancery held that a control group of stockholders and their director designees breached their fiduciary duties in approving a recapitalization of Nine Systems Corporation because the recapitalization was the result of an unfair process, even though it was accomplished at a fair price.

The opinion is important because, at a general level, it involved a fairly typical fact pattern. As a result of prior financings, three investors owned a combined 54% of the Company's equity and over 90% of the Company's senior debt. The designees of those investors, along with the CEO, filled four out of five seats on the Company's board. The Company needed a "reset" of its capital structure, along with additional funds to pursue its business plan (which included acquiring two businesses). As part of a recapitalization, two of the three existing investors agreed to invest additional funds so that the Company could remain a going concern. The board did not obtain any independent valuation of the Company in connection with the recapitalization; rather the $4 million valuation of the Company in the recapitalization was admittedly "back of the envelope" and performed by a principal of one of the investors.

When the Company was ultimately sold for approximately $175 million four years later, minority stockholders challenged the recapitalization. In a post-trial opinion, the Court held that the $4 million value attributed to the Company in the recapitalization was fair because, at the time of the recapitalization, the Company's equity had no value. This finding is similar to that of the Court of Chancery in *In re Trados Shareholder Litigation*, where the Court held that directors did not breach their fiduciary duties in approving a merger in which the common stockholders received no consideration because the common stock had no value at the time of the merger.

In *Nine Systems*, however, the Court did not stop at its analysis of the fair price component. Instead, the Court carefully reviewed the fiduciaries' conduct and found that they breached their duties by following an unfair process, evidenced by such factors as the failure to hire an independent financial advisor, the board's ignorance of how the $4 million valuation was derived, and the board's failure to obtain input from the one independent director. In doing so, the Court stated that *Trados* does not stand "for the broad proposition that a finding of fair price, where a company's common stock had no value, forecloses a conclusion that the transaction was not entirely fair"; to the contrary, the Court stated *Trados* "reinforces the defining principle of entire fairness – that a court's conclusion is *contextual*."

Despite citing precedent early in its opinion suggesting that a remedy for a breach of fiduciary duty arising out of unfair dealing could be an award of a "fairer" price, the Court ultimately declined to award monetary damages for the breach of fiduciary duty because the proof of damages offered by the plaintiffs was too speculative. The Court did, however, invite the plaintiffs to file a petition for an award of attorneys' fees and costs.

At 146 pages, the Court's opinion is full of the sort of "contextual" nuances that may differentiate the facts of the case from similar fact patterns. Nonetheless, the case is a reminder of the importance of a fair process – even if a transaction is accomplished at a fair price.

## Morris Nichols Delaware Corporate Counseling Group


**FREDERICK H. ALEXANDER**
PARTNER
(302) 351-9228
falexander@mnat.com

**MELISSA A. DIVINCENZO**
PARTNER
(302) 351-9623
mdivincenzo@mnat.com

**JAMES D. HONAKER**
PARTNER
(302) 351-9103
jhonaker@mnat.com

**ANDREW M. JOHNSTON**
PARTNER
(302) 351-9202
ajohnston@mnat.com

**ERIC KLINGER-WILENSKY**
PARTNER
(302) 351-9169
ekwilensky@mnat.com

**PATRICIA O. VELLA**
PARTNER
(302) 351-9349
pvella@mnat.com

**JEFFREY R. WOLTERS**
PARTNER
(302) 351-9352
jwolters@mnat.com



MORRIS NICHOLS ARSHT & TUNNELL

mnat.com (302) 658-9200

1201 North Market Street, 16th Floor
P.O. Box 1347
Wilmington, DE 19899-1347