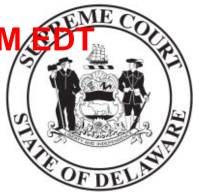
EFiled: Jul 23 2015 11:10PM EDT
Filing ID 57601534
Case Number 281,2015



IN THE SUPREME COURT OF THE STATE OF DELAWARE

MORRIS FUCHS, TRUST FBO CHAIM ABIKHZER, TRUST FBO MOISHE ABIKHZER, TRUST FBO NAFTALI ABIKHZER, SUSAN ABIKHZER, SUSAN RAUSMAN ABIKHZER TRUST, J. PAUL AMADEN, JAMES P. AMADEN, BERNARD FUCHS, THE GOLDEN FAMILY FUND, THE GREENBERG FAMILY FUND DBA ASR VENTURES, LLC, CINDY HASSAN, CINDY RAUSMAN HASSAN TRUST, ELIE HASSAN, CH TRUST FOR NATHAN HASSAN, CH TRUST FOR RACHEL HASSAN, DAVID HOROWITZ, HOWARD HOROWITZ, STEVEN HOROWITZ, EDDY HSU, CARRIE KEATING, JOHN KEATING, GREGORY LOPRETE, MICHAEL LOPRETE, TRUST FBO BARRY RAUSMAN, TRUST FBO CHAYA ETTA RAUSMAN, EMIL & JOAN RAUSMAN IREV. TRUST, HERBERT RAUSMAN, TRUST FBO JACOB J. RAUSMAN, TRUST FBO PEARL RAUSMAN, RAUSMAN 1977 LIFE INSURANCE TRUST, RIVKAH RAUSMAN, TRUST FBO 7 GRANDCHILDREN, CAROLINE RECKLER, GILLIAN RECKLER, JON RECKLER, STEPHANIE RECKLER, SHLOMO SCHON, EDWARD STRAFACI, LINDA STRAFACI, JOANNE S. VISOVSKY, MICHAEL B. VISOVSKY, BARRY WIEN, RICK A. MURPHY, THOMAS A. MURPHY, ROUNSEVELLE W. SCHAUM, and NEWPORT CAPITAL PARTNERS, INC.,

Plaintiffs-Below,
Appellants,

v.

No. 281, 2015

Court Below: Court of Chancery of the State of Delaware
Consol. C.A. No. 3940-VCN

WREN HOLDINGS, LLC, JAVVA PARTNERS, LLC, CAMERON FAMILY PARTNERSHIP, L.P., CATALYST INVESTORS, L.P., CHRISTOPHER SHIPMAN, ANDREW T. DWYER, DORT A. CAMERON, III, HOWARD KATZ, and TROY SNYDER,

Defendants-Below,
Appellees.

APPELLANTS' OPENING BRIEF

OF COUNSEL:

Lawrence D. Rosenberg
John M. Gore
Sarah A. Hunger
JONES DAY
51 Louisiana Avenue, N.W.
Washington, D.C. 20001
(202) 879-7622

Anne C. Foster (#2513)
Blake Rohrbacher (#4750)
Susan M. Hannigan (#5342)
RICHARDS, LAYTON & FINGER, P.A.
One Rodney Square
920 N. King Street
Wilmington, DE 19801
(302) 651-7700

Attorneys for Plaintiffs-Below/Appellants

Dated: July 23, 2015

TABLE OF CONTENTS

Page

TABLE OF CITATIONS iii

GLOSSARY OF ABBREVIATIONS viii

NATURE OF PROCEEDINGS 1

SUMMARY OF ARGUMENTS 6

STATEMENT OF FACTS 7

A. Plaintiffs Found SMC, Invest, And Acquire Preemptive Rights 7

B. Defendants Gain Control And Freeze Out Biderman 7

C. Defendants Implement The Transactions 9

D. Defendants Receive Exclusive Option And Improved Terms 10

E. Defendants Conceal The Transactions And Sell SMC 11

F. The Chancery Court's Findings Of Grossly Unfair Process 12

ARGUMENT 14

I. THE CHANCERY COURT'S FINDINGS THAT DEFENDANTS ENGAGED IN GROSSLY UNFAIR DEALING COMPEL DISGORGEMENT OR DAMAGES 14

A. Question Presented 14

B. Standard And Scope of Review 14

C. Merits of Argument 14

1. The Chancery Court's Findings Of Breaches Of The Duty Of Loyalty Require Disgorgement Or Damages 14

2. The Chancery Court Erred In Failing To Award Disgorgement For Unjust Enrichment 21

II. THE CHANCERY COURT ERRED IN FAILING TO AWARD DAMAGES UNDER THE ENTIRE FAIRNESS STANDARD 23

A. Question Presented 23

B. Standard And Scope of Review 23

C. Merits of Argument 23

1. The Chancery Court Improperly Relieved Defendants Of Their Burden To Prove An Entirely Fair Price 24

TABLE OF CONTENTS
(continued)

Page

2. The Chancery Court Wrongly Excluded The "Not Speculative" e-Media And NaviSite Acquisitions 27

3. The Chancery Court Improperly Ignored The Contemporaneous Management Projections 32

III. THE CHANCERY COURT ERRED IN FAILING TO AWARD DAMAGES ON PLAINTIFFS' DISCLOSURE CLAIM 40

A. Question Presented 40

B. Standard And Scope of Review 40

C. Merits of Argument 40

IV. DEFENDANTS OWED FIDUCIARY DUTIES TO PREFERRED A STOCKHOLDERS 45

A. Question Presented 45

B. Standard And Scope of Review 45

C. Merits of Argument 45

V. THE COURT MISCALCULATED ATTORNEYS' FEES AND COSTS 48

A. Question Presented 48

B. Standard And Scope of Review 48

C. Merits of Argument 48

CONCLUSION 50

TABLE OF CITATIONS

Page(s)

CASES

Anadarko Petroleum Corp. v. Panhandle Eastern Corp.,
545 A.2d 1171 (Del. 1988) 46

Arnold v. Soc'y for Sav. Bancorp,
650 A.2d 1270 (Del. 1994) 40, 41, 42

Associated Imports, Inc. v. ASG Indus., Inc.,
1984 WL 19833 (Del. Ch. June 20, 1984),
aff'd 497 A.2d 787 (Del. 1985) 26, 33, 36

Bigelow v. RKO Radio Pictures,
327 U.S. 251 (1946)..15, 16, 17, 25

Bomarko, Inc. v. Int'l Telecharge, Inc.,
794 A.2d 1161 (Del. Ch. 1999) 16, 24, 25

Cede & Co. v. JRC Acquisition Corp.,
2004 WL 286963 (Del. Ch. Feb. 10, 2004)..36, 38

Cede & Co. v. Technicolor, Inc.,
2003 WL 23700218 (Del. Ch. Dec. 31, 2003), *rev'd in part on other grounds*, 884 A.2d 26 (Del. 2005) 32

Cinerama, Inc. v. Technicolor, Inc.,
663 A.2d 1156 (Del. 1995) 42, 43

Cooper v. Pabst Brewing Co.,
1993 WL 208763 (Del. Ch. June 8, 1993)..36

Delaware Open MRI Radiology Assocs., P.A. v. Kessler,
898 A.2d 290 (Del. Ch. 2006) ....*passim*

Doft & Co. v. Travelocity.com Inc.,
2004 WL 1152338 (Del. Ch. May 20, 2004)..25, 37

TABLE OF CITATIONS
(continued)

Page(s)

Emerald Partners v. Berlin,
726 A.2d 1215 (Del. 1999) 45

Fleer Corp. v. Topps Chewing Gum, Inc.,
539 A.2d 1060 (Del. 1988) 21

Gentile v. Rossette,
2010 WL 2171613 (Del. Ch. May 28, 2010) 32, 34

Gesoff v. IIC Indus., Inc.,
902 A.2d 1130 (Del. Ch. 2006) 15

Gilbert v. MPM Enters., Inc.,
709 A.2d 663 (Del. Ch. 1997) 32, 35

Global GT LP v. Golden Telecom, Inc.,
993 A.2d 497 (Del. Ch. 2010), *aff'd*, 11 A.3d 214 (Del.) 34, 36

Henke v. Trilithic, Inc.,
2005 WL 2899677 (Del. Ch. Oct. 28, 2005) 36, 38

Henne v. Balick,
146 A.2d 394 (Del. 1958) 20

HMG/Courtland Props., Inc. v. Gray,
749 A.2d 94 (Del. Ch. 1999) 20

Huff Fund Inv. P'ship v. CKx, Inc.,
2013 WL 5878807 (Del. Ch. Nov. 1, 2013) 32, 35, 38

IM2 Merchandising & Mfg., Inc. v. Tirex Corp.,
2000 WL 1664168 (Del. Ch. Nov. 2, 2000) 47

In re Dunkin' Donuts S'holders Litig.,
1990 WL 189120 (Del. Ch. Nov. 27, 1990) 49

TABLE OF CITATIONS
(continued)

Page(s)

In re Emerging Commc'ns, Inc. S'holders Litig.,
2004 WL 1305745 (Del. Ch. May 3, 2004) 32, 36

In re J.P. Morgan Chase & Co. S'holder Litig.,
906 A.2d 766 (Del. 2006) 44

In re Mobilactive Media, LLC,
2013 WL 297950 (Del. Ch. Jan. 25, 2013) 15, 16

In re Orchard Enters., Inc.,
2012 WL 2923305 (Del. Ch. July 18, 2012) 33

In re S. Peru Copper Corp. S'holder Derivative Litig.,
52 A.3d 761 (Del. Ch. 2011), *aff'd Am. Mining Corp. v. Theriault*,
51 A.3d 1213 (Del. 2012) 16

In re Shell Oil Co.,
607 A.2d 1213 (Del. 1992) 27

In re Tyson Foods, Inc.,
919 A.2d 563 (Del. Ch. 2007) 42, 44

In re Walt Disney Co. Derivative Litig.,
906 A.2d 27 (Del. 2006) 14, 23, 40

Int'l Telecharge, Inc. v. Bomarko, Inc.,
766 A.2d 437 (Del. 2000) .... *passim*

Kahn v. Household Acquisition Corp.,
591 A.2d 166 (Del. 1991) 37

Kahn v. Tremont Corp.,
694 A.2d 422 (Del. 1997) 15, 24, 25

Lynch v. Vickers Energy Corp.,
383 A.2d 278 (Del. 1977) 40, 41, 42

TABLE OF CITATIONS
(continued)

Page(s)

M.P.M. Enters., Inc. v. Gilbert,
731 A.2d 790 (Del. 1999) 38

Malone v. Brincat,
722 A.2d 5 (Del. 1998) 40

Merion Capital, L.P. v. 3M Cogent, Inc.,
2013 WL 3793896 (Del. Ch. July 8, 2013) 33

Neal v. Ala. By-Prods. Corp.,
1990 WL 109243 (Del. Ch. Aug. 1, 1990) 36

Nemec v. Shrader,
991 A.2d 1120 (Del. 2010) 21, 22

Omnicare, Inc. v. NCS Healthcare, Inc.,
809 A.2d 1163 (Del. Ch. 2002) 47

ONTI, Inc. v. Integra Bank,
751 A.2d 904 (Del. Ch. 1999) 27, 28, 29, 30

QC Commc'ns, Inc. v. Quartarone,
2014 WL 3974525 (Del. Ch. Aug. 15, 2014) 22

Reis v. Hazelett Strip-Casting Corp.,
28 A.3d 442 (Del. Ch. 2011) 18, 19, 20

Saliba v. William Penn P'ship,
2010 WL 1641139 (Del. Ch. Apr. 12, 2010),
aff'd 13 A.3d 749 (Del. 2011) 48

Seinfeld v. Coker,
847 A.2d 330 (Del. Ch. 2000) 49

Simons v. Cogan,
549 A.2d 300 (Del. 1988) 45, 46

TABLE OF CITATIONS
(continued)

Page(s)

Sugarland Indus., Inc. v. Thomas,
420 A.2d 142 (Del. 1980) 48, 49

Thorpe v. CERBCO, Inc.,
676 A.2d 436 (Del. 1996) 15, 16

TV58 Ltd. P'ship v. Weigel Broad. Co.,
1993 WL 285850 (Del. Ch. July 22, 1993) 26, 33, 36

Weinberger v. UOP, Inc.,
457 A.2d 701 (Del. 1983) 26, 27

STATUTES

8 *Del. C.* § 228(e)..40

OTHER AUTHORITIES

Jay B. Abrams, Quantitative Business Valuation; a Mathematical
Approach for Today's Professionals (2d ed. 2010)...39

Aswath Damodaran, The Dark Side of Valuation (2d ed. 2010)............................33

Ronald J. Gilson & Jeffrey N. Gordan, *Controlling Controlling Shareholders*,
152 U. Pa. L. Rev. 785 (2003)..20

GLOSSARY OF ABBREVIATIONS

Board	Board of Directors of Streaming Media Corporation
Defendants	Wren Holdings, LLC; Javva Partners, LLC; Cameron Family Partnership, L.P.; Catalyst Investors, L.P.; Christopher Shipman; Andrew T. Dwyer; Dort A. Cameron, III; Howard Katz; Troy Snyder
Fund Defendants	Wren Holdings, LLC; Javva Partners, LLC; Catalyst Investors, L.P.
Plaintiffs	Morris Fuchs; Trust FBO Moishe Abikhzer; Susan Adbikhzer; Susan Rausman Abikzher Trust; J. Paul Amaden; James P. Amaden; Bernard Fuchs; The Golden Family Fund; The Greenberg Family Fund DBA ASR Ventures, LLC; Cindy Rausman Hassan Trust; Elie Hassan; David Horowitz; Howard Horowitz; Steven Horowitz; Carrie Keating; John Keating; Gregory Loprete; Trust FBO Barry Rausman; Trust FBO Chaya Etta Rausman; Herbert Rausman; Trust FBO Pearl Rausman; Rausman 1997 Life Insurance Trust; Rivkah Rausman; Trust FBO 7 Grandchildren; Caroline Reckler; Gillian Reckler; Jon Reckler; Stephanie Reckler; Shlomo Schon; Edward Strafaci; Linda Strafaci; Joanne S. Visovsky; Michael B. Visovsky; Rick A. Murphy; Thomas A. Murphy; Rounsevelle W. Schaum; and Newport Capital Partners, Inc.
Preferred A Plaintiffs	Cindy Hassan; Trust FBO Chaim Abikhzer; Trust FBO Naftali Abikhzer; Nathan Hassan; Rachel Hassan; Trust FBO Jacob Rausman; Emil & Joan Rausman Irrevocable Trust; Barry Wien and Eddy Hsu; Susan Rausman Abikhzer; Herbert Rausman; Rivkah Rausman; Trust FBO Barry Rausman; Trust FBO Moishe Abikhzer; and Elie Hassan.
SMC or the Company	Streaming Media Corporation, later known as Nine Systems Corporation

NATURE OF PROCEEDINGS

The Chancery Court found that Defendants seized control of SMC in 2002 and "breached their fiduciary duties" to Plaintiffs through "a grossly inadequate process" and a pattern of "bad faith," "knowing," and "intentional" misconduct. 9/4/14 Op. 1, 7, 51, 118-23 ("Op."); 5/7/15 Op. 6 ("Att'y Fees Op."). Defendants orchestrated a series of undisclosed, self-benefitting transactions ("Transactions") that dramatically diluted Plaintiffs' minority-stockholder equity and increased the equity share held by Defendants. Op. 120. The court's findings exhaustively document Defendants' startling and egregious misconduct:

- Defendants exhibited an "utter failure to understand th[eir] fiduciary relationship" to the minority stockholders, including Plaintiffs, *id.* 90-91;
- Defendants "knowingly excluded" the only independent director from "at least one Board meeting," failed to provide him with "important materials on the same timeline as the other directors," and ignored his "harshly worded objection" to the Transactions and reminder that their fiduciary duties extended "to all of [SMC's] shareholders," *id.* 20-21, 88;
- Defendants used a cursory, "back of the envelope" valuation crafted by a "conflicted" investor and never obtained any independent valuation or financial analysis, *id.* 4-7, 91-92;
- Defendants promised to inform the minority stockholders of the Transactions, but then never did so before the fact, even though many

Plaintiffs held preemptive rights, *id.* 29 n.100; 34;

- Defendants' sole disclosure was a post-Transaction Fall 2002 Update that "was materially misleading and inconsistent with the Board's fiduciary duties" because it failed to disclose "who participated in the [Transactions] and on what terms," *id.* 94;
- Defendants failed to carry their "burden of proof" because the Transactions marred by their misconduct were "not entirely fair," *id.* 120.

Defendants' breaches of fiduciary duty and concealment came to light only years later, when Defendants sought to sell the Company. As a result of their self-dealing, Defendants reaped $150 million in that sale while Plaintiffs, who had owned 26% of SMC before the Transactions, received less than 2% of the price.

This Court has emphasized that where, as here, defendants breach the duty of loyalty to minority stockholders, especially through self-dealing, recovery "is not to be determined narrowly" and "harsher rules come into play" in order "to discourage disloyalty." *Int'l Telecharge, Inc. v. Bomarko, Inc.*, 766 A.2d 437, 441 (Del. 2000). Indeed, under established Delaware law, the Chancery Court's findings, without more, required Defendants to disgorge the $118.6 million in ill-gotten profit they secured through the Transactions, or at a minimum to pay rescissory damages for the harm they inflicted by expropriating Plaintiffs' equity. The court itself even concluded that Defendants' breaches of fiduciary duty could support a damages award of "approximately $17.8 million" plus interest. Op. 129.

Even so, however, the Chancery Court declined to award Plaintiffs *any* damages. The court's decision therefore not only ran afoul of Delaware law, but also *rewarded* Defendants, and *penalized* Plaintiffs, for Defendants' proven fiduciary breaches and years-long concealment. The court reasoned in part that it could not award damages because of the "speculative nature of the offered proof." *Id.* 131. But this reasoning effectively reversed the burden of proof. Defendants bore the burden of proof to establish the entire fairness of the Transactions and could have prevented their own fiduciary breaches—and the court even recognized that "the fair price inquiry presented at trial was *severely hampered*" by Defendants' egregious misconduct. *Id.* 118-19 (emphasis added). Thus, any "speculative nature of the offered proof," *id.* 131, or uncertainty in the record should have defeated *Defendants*' case, not *Plaintiffs'* claim for damages for Defendants' misconduct.

But the court held its uncertainty against Plaintiffs. In so doing, it provided perverse incentives and an effective blueprint for Defendants (and other faithless fiduciaries) to expropriate minority-stockholder equity, disregard investor protections, conceal their wrongdoing, alter evidence, reap a windfall exceeding $100 million—and still almost entirely escape liability for their fiduciary breaches.

The court arrived at this result by disregarding its own findings and committing several independent legal errors, each of which warrants reversal. First, the court's own findings warranted disgorgement or rescissory damages on the

breach of fiduciary duty claim or, at a minimum, require Defendants to forfeit the unjust enrichment they snatched from Plaintiffs through "grossly unfair dealing" and "bad faith" misconduct. *Id.* 1, 7, 118–23; Att'y Fee Op. 6.

Moreover, the court independently erred when it denied damages based upon Defendants' fatally flawed backward-looking fair price analysis. No fewer than five contemporaneous valuations showed that SMC, a start-up company in the nascent internet streaming industry poised for explosive growth, had substantial value at the time of the Transactions: (i) an implied valuation of $22.8 million arising out of a third-party transaction; (ii) an implied valuation of $25.2 million calculated from a debt conversion; (iii) an $18.1 valuation that SMC used to raise capital in November 2001; (iv) a $10 million valuation of SMC's assets alone; and (v) a pro forma valuation of $23 million in January 2002 by Defendants' hand-picked management team. Op. 97-98.

Even though Defendants continued to add their own money into SMC *in reliance upon* these valuations, the court ignored any forward-looking analysis by adopting Defendants' backward-looking litigation position that SMC was worthless. *Id.* 7. It also improperly shifted Defendants' fair price burden to Plaintiffs on a record "severely hampered" by Defendants' misconduct; valued SMC without the "not speculative" acquisitions of two companies that Defendants admitted were the very "purpose" of the Transactions; and ignored management projections that Defendants themselves credited. *Id.* 100, 118-19; A748.

The court also wrongly rejected at least two claims that each independently supported an award of damages. The court dismissed Plaintiffs' disclosure claim in a footnote, even though its finding that the Fall 2002 Update was "materially misleading," Op. 94, established that claim and entitled Plaintiffs to rescissory damages. Moreover, the court erroneously held that Defendants owed no fiduciary duties to the Preferred A Plaintiffs who had converted their debt to equity prior to the Transactions. 2/28/13 Op. 20 ("SJ Op."). And it erred in rejecting a quantum meruit determination of attorneys' fees and pursuing a novel, litigation-recovery-range analysis that miscalculated attorneys' fees by relying upon faulty valuation principles. Att'y Fees Op. 10-11.

For all of these reasons, the Court should reverse the judgments below.

Plaintiffs brought suit in 2010 and 2012, after denial of class certification in a suit brought by other minority stockholders. Op. 8. The Chancery Court granted summary judgment to Defendants on the Preferred A Plaintiffs' claims. The remainder of the case proceeded to trial in December 2013. In its post-trial opinion, the court concluded that Defendants constituted a control group and breached their fiduciary duties. It also held that "Plaintiffs are not entitled to any monetary damages" but were "granted leave to submit a petition for attorneys' fees and costs." *Id.* 146. Plaintiffs petitioned for attorneys' fees, which were granted in part. Plaintiffs now appeal.

SUMMARY OF ARGUMENTS

1. The Chancery Court erred by refusing to award disgorgement or rescissory damages compelled by its own findings that Defendants breached their fiduciary duties through self-dealing. Op. 129-31.

2. The Chancery Court erred by failing to award disgorgement or damages under the entire fairness standard based on a legally flawed fair price analysis. The court effectively shifted the burden to Plaintiffs to make an affirmative showing of unfair price on a record distorted by Defendants' misdeeds; valued SMC without the non-speculative acquisitions that were the very "purpose" of the Transactions; and ignored contemporaneous management projections of the significant value of SMC's start-up business. Op. 97-107, 130-31.

3. The Chancery Court erred in failing to award damages on Plaintiffs' disclosure claim where Defendants' sole disclosure was "materially misleading" and prevented Plaintiffs from exercising their contractual preemptive rights or litigation rights. Op. 29, 93-95.

4. The Chancery Court erred in holding that Defendants did not owe fiduciary duties to the Preferred A Plaintiffs, who converted their notes into equity before and as a necessary precursor to the Transactions. SJ Op. 20.

5. The Chancery Court erred by rejecting a quantum meruit determination of attorneys' fees, instead pursuing a novel litigation-recovery-range analysis. Att'y Fees Op. 10-11.

STATEMENT OF FACTS

The Chancery Court found that Defendants seized control of SMC in 2002 and "breached their fiduciary duties" to Plaintiffs through "a grossly inadequate process" and a pattern of "bad faith," "knowing," and "intentional" misconduct, as laid out in extensive factual detail in its opinion. Op. 1, 7, 51, 118-23; Att'y Fee Op. 6.

A. Plaintiffs Found SMC, Invest, And Acquire Preemptive Rights

SMC was founded by three of the Plaintiffs in 1999 as a streaming media services provider. Op. 12. At that time, analysts estimated that the market "would grow from $300 million in revenue in 2000 to approximately $5.7 billion in 2005." *Id*. 13. SMC "appeared to be well-positioned to take advantage of" and even "drive" this "anticipated growth." *Id*. 12-13. The remaining Plaintiffs and the Fund Defendants invested in SMC from 1999 to 2001. *Id.* 8, 37. Twenty-two Plaintiffs acquired Most Favored Nation ("MFN") rights, *id.* 83, which triggered anti-dilution protection and preemptive rights, *id.* 29 n.100.

B. Defendants Gain Control And Freeze Out Biderman

In April 2001, Defendant Christopher Shipman of Fund Defendant Catalyst authored an Investment Memorandum that outlined a plan for the Fund Defendants to advance funding to SMC, in the form of senior secured debt, that would "effectively give [them] control over the Company." Op. 15. By December 2001, the Fund Defendants "together owned 54% of the Company's stock" and "held

over 90% of the Company's senior debt." *Id.* 18. Plaintiffs then held approximately 26% of SMC's stock. *Id.* And by late 2001, the Fund Defendants controlled three of the five Board seats, with Shipman representing Catalyst, Howard Katz representing Javva, and Dort Cameron representing Wren. *Id.* 10. Despite resistance and hostility from the other directors, Abraham Biderman, who was affiliated with certain of the Plaintiffs, joined the Board in June 2001. *Id.* 12.

In late 2001, Defendants began planning an insider recapitalization "to enable the Company to [acquire]" a division of e-Media and "the streaming media group of NaviSite." *Id.* 3.[1] As the Chancery Court found, Defendants "knowingly exclude[ed]" Biderman from the first meeting to discuss the Transactions by scheduling it at a time he could not attend due to "religious obligations." *Id.* 19, 51. Defendants also did not provide him "important materials on the same timeline as the other directors." *Id.* 88. Biderman first heard of the Transactions on a December 24 call with "conflicted" investor and Defendant Andrew Dwyer. *Id.* 20.

Four days later, Biderman sent a "harshly worded objection" to Defendants' plans. *Id.*; A926. He reminded Defendants of their "fiduciary duty to all of the Company's shareholders," asked that the Transactions "be reviewed and considered by the Company's Board of Directors as a whole," expressed his "great concern" with the "possible dilution of existing shareholders' ownership interest,"

[1] The Transactions would occur in "two primary steps: (a) a conversion of certain secured debt to a new class of preferred stock; and (b) a class of convertible preferred stock to be issued in exchange for new capital that would finance the proposed acquisitions." *Id.* 20.

and pointed out that "the directors must carefully value the Company to ensure that the valuation is fair to all shareholders." Op. 21. He concluded that "[t]his is especially important given that certain shareholders, who are represented on the Company's Board of Directors, may stand to benefit as a result of the transaction." *Id.* Defendants never responded to this letter. *Id.*

C. Defendants Implement The Transactions

On January 7, 2002, the Board convened the first of a series of meetings that would ultimately "rubber stamp" the Transactions. A738; Op. 32. Dwyer "outlined the economic terms of his proposal" and "presented to the Board his valuation of the Company: $4 million." Op. 22. As the court found, this valuation "was admittedly 'back of the envelope': a series of handwritten guesstimates scratched out on a single piece of paper." *Id.* 4. "Dwyer did not share the methods he used to arrive at that figure with the directors" and "did not adequately explain the $4 million valuation when the Board approved the Recapitalization." *Id.* 22-23, 122. Defendants did not retain an independent advisor, and the court rejected the suggestion that the Board did not have "the time or money" to do so. *Id.* 92.

After two informal meetings without Biderman, the full Board met on January 10 to approve $2.5 million in funding for the e-Media and NaviSite acquisitions via consents of the "majority of the Company's senior debt holders—that is, Wren, Javva, and Catalyst." *Id.* 25. At the meeting, management presented an unopposed $23 million pro forma valuation, *id*. 27, which was consistent with

other contemporaneous valuations of $22.8 million and $25.2 million implied from the conversion ratio of securities issued to a third-party and SMC's secured debt holders, *id.* 97-98. Nevertheless, Defendants continued to base the Transactions on Dwyer's $4 million valuation. Shortly thereafter, management presented its 2002 pro forma revenue projection to the Board as $15,935,074, *id.* 31, which Dwyer admitted Defendants "ma[de] decisions upon," A746. There is no record of anyone ever expressing disagreement with these projections at that time. Op. 31. The e-Media acquisition closed on January 17, but the NaviSite acquisition was repeatedly delayed until its eventual closing on March 25. *Id.* 33-36. By then, the terms had changed. Wren and Javva put in additional funding. *Id.* 33.

D. Defendants Receive Exclusive Option And Improved Terms

Defendants gave Catalyst an undisclosed, exclusive 90-day option "in exchange for agreeing to support the Recapitalization." *Id.* 65. As the court found, this option was critical to Defendants because it "favor[ed] their own interests" and rendered the Transactions a "*fait accompli*." *Id.* 92-93. "This invitation to invest was never shared with any of the Company's minority investors that, by virtue of their [MFN] rights, most likely had preemptive rights." *Id.* 29-30 n.100.

Throughout the spring and summer of 2002, Defendants "inexplicably" changed terms of the Transactions in "disregard of the Board's resolutions" and "the specific terms of the promissory notes." *Id.* 95. Defendants increased the interest rate on their own notes and made their accrued interest convertible. *Id.*

These actions alone increased their ownership in SMC by 7.35% above the limits set in their promissory notes. *Id.* In total, the Fund Defendants' fully diluted stock ownership "increased from approximately 54% in January to approximately 80% by September." *Id.* 43. By contrast, Plaintiffs' ownership decreased from 26% to 2%. *Id.* At trial and through sworn declarations, Plaintiffs attested that "had they been contacted by the Defendants, they were ready, willing, and able to provide additional capital" to SMC at the time of the Transactions. *Id.*

E. Defendants Conceal The Transactions And Sell SMC

Defendants had been told by Biderman and Emily Grad, who attended the March 6 meeting in Biderman's stead, that they needed to inform all stockholders of the Transactions and changes to the capitalization table. Op. 34. Defendants agreed to this, but never followed through. Their sole communication to the stockholders, the post-Transactions Fall 2002 Update, was "materially misleading" and "inadequate," omitting the "key terms"—"most importantly, who was receiving the convertible preferred stock and on what terms." *Id.* 4, 93. Defendants also altered minutes of Board meetings a year after the fact. *Id.* 24 n.78. As the court held, "the Board sought to avoid full and fair communications with [SMC's] stockholders." *Id.* 46.

The Board then effectively disappeared from minority stockholders until 2006. *Id.* 45. It failed to hold annual shareholder meetings and did not inform stockholders of SMC's move to California. *Id.* In 2005, Defendants refused to

disclose SMC's capitalization table because they feared the requestor "would not be happy," *id.*, a "scene [that] epitomized the Defendants' conduct," *id.* 45-46. In a February 2006 letter to stockholders, the Board resurfaced to acknowledge "sporadic shareholder confusion," but did not disclose any details of the Transactions. *Id.* 47. It promised "to send each shareholder a letter with their shareholdings," but, "consistent with its pattern of conduct," never did. *Id.* 48.

In November 2006, Defendants sold SMC for $175 million. *Id.* 52. During the approval of the merger, Defendants again "intentionally scheduled" a meeting "so that Biderman could not attend." *Id.* 51. "Defendants received approximately $150 million" in the sale, while Plaintiffs received $3 million combined. *Id.* 52. Wren and Java "received almost a 2,000% return" on the Preferred B-1 stock. *Id.*

F. The Chancery Court's Findings Of Grossly Unfair Process

The court held that Plaintiffs had standing to bring a direct expropriation claim because (1) the Fund Defendants constituted "a control group that, through their collective majority ownership of [SMC], effected the [Transactions] to the exclusion and dilution of the Plaintiffs," and (2) "a majority of the directors who approved the [Transactions] were conflicted due to their fiduciary relationships with the entities that received the opportunity, not shared with the [SMC]'s other stockholders, to invest in the dilutive, convertible preferred stock." *Id.* 7.

The court found that Defendants effectuated the Transactions through "grossly unfair dealing." *Id.* 87. Defendants used a valuation that was not

"adequately understood," and was developed solely by the "conflicted" Dwyer, with no attempt to utilize an independent financial advisor. *Id.* 91-92. They gave only Catalyst an opportunity to invest, in spite of Plaintiffs' preemptive rights. *Id.* 92-93. Defendants sent a "materially misleading" "notice" document to stockholders after the fact—"powerful evidence of unfair dealing." *Id.* 93-94. They "inexplicably" changed terms of the Transactions in "disregard of the Board's resolutions" and "the specific terms of the promissory notes." *Id.* 95.

The court thus concluded that "Wren, Javva, Catalyst, Dort Cameron, Katz, Shipman, and Snyder breached their fiduciary duties, and Dwyer (and to the extent they were not a control group, Wren, Javva, and Catalyst) aided and abetted those breaches." *Id.* 7, 146. Nonetheless, the court held that Defendants "approved and implemented" the Transactions "at a fair price," *id.* 7, and rejected Plaintiffs' disclosure and unjust enrichment claims on holdings that each was subsumed within the entire fairness analysis, *id.* 93 n.325; 125. The court further held that "Plaintiffs are not entitled to any monetary damages" but were "granted leave to submit a petition for attorneys' fees and costs." *Id.* 146. Plaintiffs petitioned for attorneys' fees and costs in the amount of $11,427,195.23. The court granted the petition in part, denied it in part, and awarded $2 million, finding that Defendants acted in "bad faith." Att'y Fees Op. 6, 11. This appeal followed.

ARGUMENT

I. THE CHANCERY COURT'S FINDINGS THAT DEFENDANTS ENGAGED IN GROSSLY UNFAIR DEALING COMPEL DISGORGEMENT OR DAMAGES

A. Question Presented

Did the Chancery Court err in refusing to award disgorgement or rescissory damages compelled by its own findings that Defendants engaged in grossly unfair dealing and altered the record? This question was preserved for appeal. A555-56.

B. Standard And Scope of Review

This Court reviews questions of law de novo. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 48 (Del. 2006).

C. Merits of Argument

The Chancery Court expressly held that Defendants "breached their fiduciary duties" by orchestrating the Transactions through a "grossly inadequate process" and "bad faith," "knowing," and "intentional" misconduct. Op. 1, 7, 51, 119-23; Att'y Fees Op. 6. These findings required disgorgement of $118.6 million in Defendants' ill-gotten profit or rescissory damages of at least $17.8 million for their expropriation of Plaintiffs' equity. The court therefore erred in failing to award disgorgement or damages, and the Court should reverse.

1. The Chancery Court's Findings Of Breaches Of The Duty Of Loyalty Require Disgorgement Or Damages

Where defendants breach the duty of loyalty to minority stockholders, especially through self-dealing, recovery "is not to be determined narrowly" and

"harsher rules come into play" in order "to discourage disloyalty." *Bomarko*, 766 A.2d at 441. Delaware courts thus wield "very broad" power to fashion "equitable and monetary relief under the entire fairness standard." *Id.* at 440.

Delaware courts have established a "rule, inveterate and uncompromising in its rigidity," that "where the defendant breaches the duty of loyalty, the infringing party must disgorge all profits and equity." *In re Mobilactive Media, LLC*, 2013 WL 297950, at *23 (Del. Ch. Jan. 25, 2013) (awarding disgorgement damages); *Thorpe v. CERBCO, Inc.*, 676 A.2d 436 (Del. 1996) (same). This has the effect of deterring future misconduct by "eliminat[ing] the possibility of profit flowing to defendants from the breach of the fiduciary relationship." *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1154 (Del. Ch. 2006). This Court also has specifically held that "rescissory damages" are "appropriate" where a defendant fails to carry its entire fairness burden. *Bomarko*, 766 A.2d at 440.

Delaware law, moreover, holds any uncertainties in the amount or proof of damages against defendants who breach their fiduciary duties, not plaintiffs who fall prey to such breaches. This rule complements the rule that defendants bear the burden of proof in an entire fairness inquiry, including the burden to prove fairness of both process and price. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997). Furthermore, "[t]he most elementary conceptions of justice and public policy require that the wrongdoer shall bear the risk of the uncertainty which his own wrong has created." *Bigelow v. RKO Radio Pictures*, 327 U.S. 251, 265 (1946).

Indeed, "[i]t would be an inducement to make wrongdoing so effective and complete in every case as to preclude any recovery, by rendering the measure of damages uncertain." *Id.* at 264-65.

Delaware courts thus have even adjusted their "remedy calculation" when faced with such uncertainty. *In re S. Peru Copper Corp. S'holder Derivative Litig.*, 52 A.3d 761, 816 n.190 (Del. Ch. 2011), *aff'd Am. Mining Corp. v. Theriault*, 51 A.3d 1213 (Del. 2012). In *Bomarko*, the Chancery Court found that the defendant's misconduct made it "impossible to know what *would have* happened if he had acted in accordance with his fiduciary duties instead of his personal economic interests." *Bomarko v. Int'l Telecharge, Inc.*, 794 A.2d 1161, 1170-71 (Del. Ch. 1999) (emphasis in original). Thus, in calibrating a remedy, the court construed the uncertainty in the record against the defendant and awarded damages to the plaintiffs. *Id.* at 1178-84. The court expressly noted that while its damages award might over-compensate the plaintiffs, it was "appropriate, given the nature of [the] misconduct" and "necessary to avoid short-changing plaintiffs." *Id*. at 1184-85. This Court affirmed. 766 A.2d 437 (Del. 2000).

Here, the Chancery Court held that the Transactions were "not entirely fair" and "breached [Defendants'] fiduciary duties," including the duty of loyalty. Op. 118, 120. Thus, it should have ordered Defendants to disgorge their $118.6 million in ill-gotten gains under Delaware law. *In re Mobilactive Media*, 2013 WL 297950, at *23; *Thorpe*, 676 A.2d 436. Alternatively, the court should have awarded

"rescissory damages." *Bomarko*, 766 A.2d at 440. The court itself indicated that rescissory damages for Defendants' breaches at a minimum would be "approximately $17.8 million, plus interest." Op. 129.[2]

The court, however, declined to award Plaintiffs the disgorgement or damages otherwise compelled by its own findings. The court reasoned in part that it could not award damages because of the "speculative nature of the offered proof." *Id.* 131. But as the court itself found, the record "was severely hampered by" Defendants' egregious misconduct. *Id.* 118-19. Thus, "[t]he most elementary conceptions of justice and public policy" required that *Defendants*, not *Plaintiffs*, "bear the risk of th[is] uncertainty." *Bigelow*, 327 U.S. at 265. By holding otherwise, the court created perverse incentives and allowed these faithless fiduciaries to engage in misconduct that hampered any retrospective valuation and rendered the amount of damage uncertain, thereby avoiding paying for their wrongs.

Delaware law instead required potentially *over*-compensating Plaintiffs "given the nature of [Defendants'] misconduct, and . . . to avoid short-changing plaintiffs." *Bomarko*, 794 A.2d at 1184-85. This equitable principle requiring Defendants to bear the brunt of their misdeeds is "an ancient one," *Bigelow*, 327

[2] The $118.6 million in disgorgement and $17.8 in rescissory damages set out the range of awards established by the record, and are unaffected by the Chancery Court's legal errors in its fair price analysis addressed in Part II. As explained in Part II, when those fair price errors are corrected, the rescissory damages to which Plaintiffs are entitled increase to at least $48.9 million.

U.S. at 265, and corresponds with economic principles: Defendants had, and went out of their way to deepen and exploit, an overwhelming information advantage over Plaintiffs. And as a control group, they were the lowest-cost avoiders; only they could have prevented their breaches of fiduciary duty and made full and proper disclosures to Plaintiffs.

The court also adopted Defendants' post hoc litigation valuation of SMC and concluded that the Transactions were completed "at a fair price." Op. 7. As explained below, the court's fair price analysis contradicts Defendants' real-time actions and should be reversed. *See infra* Part II. But even under the court's incorrect analysis, Defendants still are required to pay for their proven fiduciary breaches. "The fair price analysis is part of the entire fairness standard of review; it is not itself a remedial calculation," so factors "such as coercion, overreaching, the misuse of confidential information, or secret conflicts (a list that is explicitly nonexclusive) could lead a court to award a monetary remedy . . . that differs from what appraisal would generate." *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 465–67 (Del. Ch. 2011).

Those factors are present in abundance in the court's own findings. For example, Defendants ignored and froze out the sole independent director, who *specifically warned them in writing* that the process was inadequate and that *the valuation would be unfair to minority stockholders*. Op. 21; A926. They established no special committee and retained no outside advisors; indeed, they

took no steps of any kind to mitigate their self-interestedness. Op. 3, 91-92. Dwyer, who was neither an officer nor a director but stood, along with Cameron, to gain the most from the Transactions, conjured a valuation number without supporting documentation, which the other Defendants accepted without inquiry into its methodology. *Id.* 3-4, 22, 91. And, a year after the Transactions, they altered several of the relevant sets of Board minutes. *Id.* 24-25; A952; A955.

Moreover, many Plaintiff stockholders held preemptive rights, Op. 29 n.100—yet Defendants failed to honor those rights. To the contrary, Defendants went to extraordinary lengths to conceal the Transactions. When Grad reminded the Board of its duty to inform minority stockholders of the Transactions, Defendants promised to do so but then did not. *Id.* 34-35; A1289. Defendants' *only* disclosure, the Fall 2002 Update, was "materially misleading," omitting who had benefited from the transactions, and on what terms. Op. 93-94. They did not communicate to stockholders that the Company had moved across the country, held no annual stockholder meetings, and when they resurfaced years later, sent a letter acknowledging "sporadic shareholder confusion" and promising to send details of holdings—which they never did. *Id.* 4, 47-48; A971.

Thus, even if the Chancery Court's fair price analysis were correct, Defendants' "grossly unfair process" should have led the court "to award a monetary remedy" of disgorgement or rescissory damages. *Reis*, 28 A.3d at 465–67. At an absolute minimum, the Court should award the $17.8 million in damages

mentioned by the Chancery Court. As the court noted, this case squarely presents "one of the long-standing puzzles of Delaware corporate law: for a conflicted transaction reviewed . . . under the entire fairness standard, to what else are shareholders entitled beyond a fair price?" Op. 1.[3] Recognizing that "[a]t least doctrinally, stockholders may be entitled to more than merely a fair price," the court nonetheless declined to award damages due to the purported "difficulty . . . in quantifying the value" owed to Plaintiffs. *Id.* 1-2. But, as explained, recovery for a breach of the duty of loyalty "is not to be determined narrowly," *Bomarko*, 766 A.2d at 441, and the fact that "the damage is very difficult to measure will not preclude" a damages award, *Henne v. Balick*, 146 A.2d 394, 396 (Del. 1958).

Moreover, the Chancery Court *actually quantified* a possible measure of damages to remedy Defendants' breaches of the duty of loyalty—"approximately $17.8 million" as "the amount of consideration [Plaintiffs] would have received in the Akamai Merger had they participated in the [Transactions] pro rata." Op. 129.

Finally, Plaintiffs also are entitled to damages for at least three discrete harms identified by the Chancery Court:

- Defendants authorized Wren and Javva to take 7.35% of the equity reserved for e-Media, without notifying Biderman or Plaintiffs, and in excess of their authorized ownership. *Id.* 39. Plaintiffs' damages equal $3.34 million.

---

[3] *See also Reis*, 28 A.3d at 467; *HMG/Courtland Props., Inc. v. Gray*, 749 A.2d 94, 116 (Del. Ch. 1999); Ronald J. Gilson & Jeffrey N. Gordan, *Controlling Controlling Shareholders*, 152 U. Pa. L. Rev. 785, 798 n.41 (2003).

- Javva received a $50,000 convertible note, never ratified by the Board, and later converted it to equity. *Id*. Plaintiffs' damages equal $327,250.
- Although the Board approved the convertible promissory notes to accrue at 10% interest, "the interest rates were retroactively increased to 12%" "without Board authorization." *Id.* Damages from this total $191,100.[4]

2. The Chancery Court Erred In Failing To Award Disgorgement For Unjust Enrichment

Alternatively, the Chancery Court's findings require disgorgement of $118.6 million for Defendants' unjust enrichment. Even where precisely measuring damages is difficult or impossible, unjust enrichment prohibits "retention of a benefit to the loss of another that runs counter to the fundamental principles of justice or equity and good conscience." *Fleer Corp. v. Topps Chewing Gum, Inc.*, 539 A.2d 1060, 1062 (Del. 1988). Here, Defendants' documented misconduct as found by the court allowed them to profit to the tune of $118.6 million. Accordingly, a remedy for "the benefit unjustifiably conferred upon" Defendants in that amount is warranted. *Nemec v. Shrader*, 991 A.2d 1120, 1130 (Del. 2010).

The Chancery Court, however, did not even "address [the] unjust enrichment claim" against Wren, Javva, and Catalyst because "Plaintiffs are entitled to receive

---

[4] The $3.34 million award represents Plaintiffs' share of the equity wrongfully taken from SMC at the Akamai sales price. Op. 39, 43, 52. The $326,671 award represents Plaintiffs' portion of the excess shares that Javva received as a result of the unauthorized convertible loan. *Id.* 39, 42; A1272-85. Finally, the $191,000 award is Plaintiffs' portion of the equity that Defendants gained through the unauthorized increase in interest rates. A947.

only one recovery as between these duplicative claims." Op. 125. That unremarkable principle is entirely inapposite: it prevents *duplicative* recovery for a single harm actionable on more than one claim, but does not foreclose damages on one claim merely because the court concludes that damages are unavailable on another claim. *See, e.g.*, *QC Commc'ns, Inc. v. Quartarone*, 2014 WL 3974525, at *13 (Del. Ch. Aug. 15, 2014) (cited at Op. 126). Thus, the court in *Quartarone* declined to address the unjust enrichment claim because it had *already awarded* damages on the fiduciary duty claim, not because it had *declined* to do so. *See id.* There was no risk of duplicative recovery here because the court *did* decline to award damages on the entire fairness claim.

The court also noted that "it would appear difficult for the Plaintiffs to establish an impoverishment where the Board approved the Recapitalization at a fair price because the Plaintiffs' stock had no value." Op. 126 n.416. As explained below, the court's fair price analysis is erroneous. *See infra* Part II. But even if it could stand, "[i]mpoverishment does not require that the plaintiff seeking a restitutionary remedy suffer an actual financial loss, as distinguished from being deprived of the benefit unjustifiably conferred upon the defendant." *Nemec*, 991 A.2d at 1130 n.37. Thus, an unjust enrichment remedy is appropriate to prevent Defendants from retaining the ill-gotten windfall that they in good conscience ought not keep, even if Plaintiffs suffered no "actual financial loss" through the Transactions. *Id.*

II. THE CHANCERY COURT ERRED IN FAILING TO AWARD DAMAGES UNDER THE ENTIRE FAIRNESS STANDARD

A. Question Presented

Did the Chancery Court also err in refusing to award damages under the entire fairness standard when it performed a legally flawed fair price analysis? This question was preserved for appeal. A534-35; A540-55.

B. Standard And Scope of Review

This Court reviews questions of law de novo and overturns findings of fact when they are "clearly wrong and justice so requires." *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 48 (Del. 2006).

C. Merits of Argument

In addition to the erroneous failure to award damages given its own findings, *see supra* Part I, the Chancery Court independently erred in failing to award damages under the entire fairness standard when it adopted Defendants' backward-looking fair price analysis, which was based on start-up SMC's last twelve months of revenue. That analysis contradicted both Defendants' real-time actions in hatching the Transactions to invest millions of dollars in SMC, and the well-established principle favoring a forward-looking fair price analysis for most start-ups, including SMC. In the first place, the court improperly relieved Defendants of their fair price burden and rewarded their breaches by effectively shifting the burden to Plaintiffs on a record "severely hampered" by Defendants' misdeeds. Op. 118-19. Moreover, the court erred when it excluded from its fair price analysis

the "not speculative" acquisitions of e-Media and NaviSite that Defendants admitted were the very "purpose" of the Transactions. *Id.* 100-01. And it again erred when it ignored contemporaneous management projections that reflected the substantial prospective value of SMC's start-up business. *Id.* 107. Each of these three errors independently compels reversal.

1. The Chancery Court Improperly Relieved Defendants Of Their Burden To Prove An Entirely Fair Price

"Although often applied as a bifurcated or disjunctive test, the concept of entire fairness requires the court to examine all aspects of the transaction in an effort to determine whether the deal was entirely fair." *Tremont*, 694 A.2d at 432. Thus, an unfair process can be "so intertwined with," and so "infect[]," the price that the price is necessarily unfair. *Id.* at 432; *Bomarko*, 794 A.2d at 1183.

This is a quintessential case in which the unfair process was "so intertwined with," and so "infect[ed]," the price Defendants paid that the price was not fair. *Tremont*, 694 A.2d at 432; *Bomarko*, 794 A.2d at 1183. The court concluded that Defendants' process was so "grossly unfair" that it *independently* proved that Defendants "breached their fiduciary duties." Op. 118-20. On this record, the court should have held that the price infected by that process was unfair. *Tremont*, 694 A.2d at 432; *Bomarko*, 794 A.2d at 1183. Indeed, Defendants' misconduct—*e.g.*, freezing out Biderman, eschewing independent advice, and concealing the Transactions from minority stockholders, who were a source of potential funding and many of whom *held preemptive rights*—shows that the price was unfair. The

court nonetheless held that the price was fair—an independent legal error warranting reversal.

The court's rationale for this fatally flawed fair price holding merely compounded its legal errors. The court declined to award damages based on what it viewed as the "speculative nature of the offered proof" on fair price. Op. 131. But because Delaware law places the burden to prove fair price on *Defendants*, any evidentiary gaps should have defeated Defendants' case, not Plaintiffs' claim for damages. *See Tremont*, 694 A.2d at 432. These principles ring especially true here because the court expressly found that Defendants' misconduct "severely hampered . . . the fair price inquiry presented at trial," including by creating an "informational vacuum" stretching back to 2001. Op. 118-19, 122; *see supra* Part I.C.1; *Bigelow*, 327 U.S. at 265; *Bomarko*, 794 A.2d at 1179-84.

The court's improper shifting of the fair price burden dictated the outcome here: *Plaintiffs* were the *only* parties to present a fair price analysis that conformed with Delaware law, while *Defendants* presented *no* such analysis. As even the court acknowledged, it is "the general preference of Delaware courts for fair price analyses to feature multiple (and preferably consistent) valuation methodologies that are derived from contemporaneous management projections." Op. 107 n.364; *see also Doft & Co. v. Travelocity.com Inc.*, 2004 WL 1152338, at *5 (Del. Ch. May 20, 2004) ("Delaware law clearly prefers valuations based on contemporaneously prepared management projections."). A fair price analysis

therefore is forward-looking, frequently involves a discounted cash flow analysis ("DCF"), and must incorporate the company's "future prospects." *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983). This is especially true for start-up companies like SMC, for which forward-looking projections and DCF measures are ordinarily the best and most reliable indicators of value. *See, e.g.*, *TV58 Ltd. P'ship v. Weigel Broad. Co.*, 1993 WL 285850, at *4 (Del. Ch. July 22, 1993); *Associated Imports, Inc. v. ASG Indus., Inc.*, 1984 WL 19833, at *15-16 (Del. Ch. June 20, 1984), *aff'd* 497 A.2d 787 (Del. 1985).

Plaintiffs' analysis considered the contemporaneous valuations showing that SMC was worth as much as $25.2 million at the time of the Transactions, demonstrated through a DCF and other forward-looking measures that SMC was in fact worth at least $30.89 million, and proved at least $48.9 million in rescissory damages. Op. 109. In contrast, as explained below, *see infra* Parts II.C.2–3, Defendants' litigation-driven, backward-looking fair price analysis departed from their real-time view of SMC's value. It was based solely upon SMC's last twelve months of revenue, and explicitly *excluded* both the contemporaneous valuations and projections Defendants relied upon and the e-Media and NaviSite acquisitions that were the very purpose of the Transactions.

The court's shifting of the burden to Plaintiffs, therefore, not only violated Delaware law, but also concealed Defendants' complete failure of proof. If permitted to stand, this effective reversal of the burden of proof and refusal to

award damages would reward these faithless fiduciaries—and provide them a windfall of over $100 million—at the expense of the minority stockholders.

2. The Chancery Court Wrongly Excluded The "Not Speculative" e-Media And NaviSite Acquisitions

Defendants admitted that the entire "purpose of doing" the Transactions was to complete the e-Media and NaviSite acquisitions, A748, and to attempt to capture "the fortunes of the company going forward," A754. Indeed, the $3.3 million Defendants invested in SMC through the Transactions was the precise amount required to consummate the acquisitions. The Chancery Court found that these acquisitions were "not speculative" at the time of the Transactions, but excluded them from its backward-looking fair price analysis in another independent legal error prescribing reversal. Op. 100.

The fair-price inquiry encompasses examination of all factors relevant to a company's value, including its "future prospects." *Weinberger*, 457 A.2d at 711. As this Court has instructed, "facts which were known or which could be ascertained" at the time of the transaction "and throw any light on *future prospects* of the merged corporation . . . *must be considered*." *Id.* at 713. This forward-looking analysis thus considers any "specific expansion plans," *Delaware Open MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290, 315 n.51 (Del. Ch. 2006), as the company "must be viewed as an on-going enterprise . . . in the light of future prospects," *In re Shell Oil Co.*, 607 A.2d 1213, 1218 (Del. 1992). Delaware courts therefore include in valuations acquisitions that are "non-speculative" but not yet

completed at the relevant time. *Kessler*, 898 A.2d at 315; *ONTI, Inc. v. Integra Bank*, 751 A.2d 904, 910 (Del. Ch. 1999).

The *Kessler* decision is particularly instructive. At the time of the disputed merger, "the business plan of Delaware Radiology" anticipated opening three "additional MRI Centers," none of which would open until after the merger and all of which were in the preliminary planning stages. 898 A.2d at 315. In fact, the company did not secure financing for one center until ten months after the merger, did not lease a location until thirteen months after the merger, and did not open the center until after trial. *Id.* at 318. Yet the Chancery Court held that because all of the centers were part of the business plan at the time of the merger, any exclusion of "the value of [these] expansion plans" from the valuation would be subject to "ridicule." *Id.*

ONTI, too, is instructive. There, the Chancery Court used a hypothetical about a cornfield in Manhattan to explain why anticipated transactions must be included in a valuation. 751 A.2d at 911. In this hypothetical, "a valuation of that company as of the date of the merger that doesn't take into consideration the nonspeculative possibilities of developing this cornfield into something other than a cornfield is not a realistic valuation of the company." *Id.* Minority stockholders are therefore "entitled to a valuation that reflects the value of a company that owns a cornfield that can be developed into a major office center." *Id.*

Here, the Chancery Court found that the e-Media and NaviSite acquisitions

were "not speculative" at the time that Defendants approved the Transactions. Op. 100. That finding was compelled by the record: Defendants admitted at trial that these acquisitions were the "purpose" behind the Transactions and the reason they continued to invest in SMC. A748 (Dwyer explaining that they invested $2 million "for the purpose of doing the acquisitions"); A741 (Katz "invested in January of 2002 based on [his] hope that the combined entity SMC, e-Media, and NaviSite would be successful"); A754 (Cameron testifying as to "the fortunes of the company going forward"). Moreover, management's valuation and projections presented at the January 10 Board meeting included the e-Media and NaviSite acquisitions. A937. The Board voted to enter into negotiations for the acquisitions on January 7, implemented a funding plan on January 10, and completed the e-Media acquisition on January 17, *the same day* that it completed approval of the Transactions. Op. 23-25, 33.

Thus, the "not speculative" e-Media and NaviSite acquisitions should have been included in any valuation of SMC. *Id.* 100; *Kessler*, 898 A.2d at 315; *ONTI*, 751 A.2d at 910. The Chancery Court, however, sidestepped this well-established legal principle and excluded these acquisitions on the basis that "the Company, on its own, did not have the capital needed to fund either of the e-Media or NaviSite SMG acquisitions, let alone both of them." Op. 100. As its sole support for this conclusion, *id.*, the court cited one sentence from *Kessler* noting that a contemplated acquisition in that case was "within the corporation's financial

ability to capture," 898 A.2d at 317. That out-of-context statement, however, does not support the court's reading below.

The concept was raised as part of a broader discussion of the "traditional corporate opportunity" analysis, and *Kessler* never identified "hav[ing] the capital needed to fund" non-speculative acquisitions as a prerequisite for including them in a valuation. 898 A.2d at 317. And just a few paragraphs later, the *Kessler* court specifically included another contemplated acquisition in its valuation, even though the company did not have the capital to complete that acquisition at the relevant time and did not obtain it until ten months later. *Id.* at 318. Thus, *Kessler* does not establish a financial-ability-to-capture requirement. *See id.*

In any event, SMC *did* have the financial ability to capture e-Media and NaviSite in January 2002, as conclusively demonstrated by the fact that it *actually acquired* these companies. Not only did the Company raise $3.3 million from Defendants, *see* Op. 34, but Plaintiffs—an obvious potential funding source whom Defendants kept in the dark—also testified that they had the ability and desire to participate in the equity raise, *id.* 43. Contrary to the court's apparent belief, it was of no moment that SMC did not have the cash on hand to complete the acquisitions when it had ready access to ample capital to do so, including from its own stockholders. *See, e.g.*, *Kessler*, 898 A.2d at 315; *ONTI*, 751 A.2d at 910. Indeed, the court's exclusion of e-Media and NaviSite rewards Defendants' "grossly unfair" behavior: because Defendants kept for themselves the opportunity to fund

the acquisitions, they alone reaped the benefits of the Transactions. The court's exclusion from its valuation of the "not speculative" e-Media and NaviSite acquisitions—which drove Defendants to concoct the Transactions in the first instance—is reversible error.[5]

This error had a profound effect on the court's valuation analysis. Indeed, the impact of excluding e-Media and NaviSite from the valuation of SMC is perhaps best evidenced by the fact that Defendants' expert changed his valuation method for dates after January 2002 in an attempt to minimize the impact of the acquisitions on SMC's value. *See* A756-57.[6] Defendants' expert acknowledged that correcting this erroneous exclusion alone would yield a valuation of $21.2 million *even on his conservative last-twelve-months public company multiple method*. A757. That $21.2 million valuation dwarfs the $0 valuation adopted by the court and requires damages to Plaintiffs, which the Chancery Court erroneously failed to award when it excluded the "not speculative" e-Media and NaviSite acquisitions from its valuation of SMC.

---

[5] The Chancery Court also noted that changes to the capital structure "only occurred after the additional investments by Wren and Javva." Op. 101. This assertion, however, conflicts with its earlier finding that the additional investments by Wren and Javva were "an initial condition to the financing." *Id.* 39.

[6] In a footnote, the Chancery Court suggests that the bargain-basement price at which SMC purchased assets from e-Media and NaviSite cannot be squared with the much higher value for these assets calculated under an LTM multiple method. Op. 115 n.386. That is precisely the point. SMC purchased assets that Defendant Dwyer himself stated were "clearly in distress." A751. The purchase of those assets at distressed prices imparted value to SMC that should have been shared with all stockholders.

3. The Chancery Court Improperly Ignored The Contemporaneous Management Projections

The Chancery Court committed independent legal error because it disregarded contemporaneous management projections in favor of a backward-looking valuation of SMC's start-up business that rested solely on historic revenue numbers. That analysis guaranteed an erroneous and artificially low valuation of SMC, whose value lay in its future potential.

Delaware law emphasizes a "preference for the most recently prepared management projections available" in conducting valuations, *In re Emerging Commc'ns, Inc. S'holders Litig.*, 2004 WL 1305745, at *14 (Del. Ch. May 3, 2004) (cited at Op. 105), because they "are not tainted by post-merger hindsight and are usually created by an impartial body," *Cede & Co. v. Technicolor, Inc.*, 2003 WL 23700218, at *7 (Del. Ch. Dec. 31, 2003), *rev'd in part on other grounds*, 884 A.2d 26 (Del. 2005) (cited at Op. 105). Contemporaneous management projections should be ignored only in circumstances of "deliberate attempt[s]" by management to "falsify [the] projected revenues and expenses," *Gilbert v. MPM Enters., Inc.*, 709 A.2d 663, 669 (Del. Ch. 1997); "unprecedented" use of projections; and creation of projections "for the purpose of obtaining benefits outside the company's ordinary course of business," such as in anticipation of litigation, *Huff Fund Inv. P'ship v. CKx, Inc.*, 2013 WL 5878807, at *9 (Del. Ch. Nov. 1, 2013) (cited at Op. 103-04). Otherwise, a court "may not ignore" management's estimates, "regardless of whether it trusts those numbers." *Gentile*

v. Rossette, 2010 WL 2171613, at *6 n.34 (Del. Ch. May 28, 2010).

As explained, *see supra* Part II.C.1, this use of valuations based on management's earnings projections is especially warranted for a start-up company such as SMC. *See, e.g.*, *TV58 Ltd. P'ship*, 1993 WL 285850, at *4; *Associated Imports*, 1984 WL 19833, at *15-16. Financial literature also "suggest[s] steering away from multiples of either current book value or current earnings with growth companies early in the growth cycle, simply because these numbers are likely to be small and unstable." Aswath Damodaran, The Dark Side of Valuation 309 (2d ed. 2010).[7] Instead, a far more reliable "solution is to forecast the firm's operating results later in the life cycle and to use these forward revenues and earnings as the basis for valuation." *Id.* at 257.

Here, management created two sets of projections of the Company's 2002 revenues at the time of the Transactions: (1) an $11.1 million projection contained in a December 2001 Private Placement Memorandum, and (2) a $15.9 million projection sent to the Board for use in the January 17, 2002 Board meeting. Op. 16, 31. Defendants' own reliance upon and use of these projections vividly demonstrates their reliability. As the Chancery Court acknowledged, the "record does not contain any document in which the Board" or any Defendant "expressed . . . disagreement with those projections." *Id.* 31. The January 7, 2002 Board

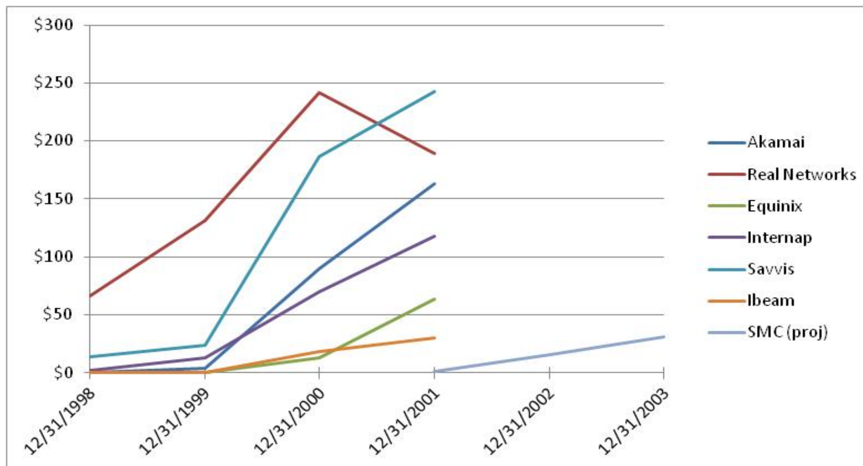
[7] Cited in *Merion Capital, L.P. v. 3M Cogent, Inc.*, 2013 WL 3793896 (Del. Ch. July 8, 2013) (Parsons, V.C.); *In re Orchard Enters., Inc.*, 2012 WL 2923305 (Del. Ch. July 18, 2012) (Strine, C.).

meeting featured a "prolonged discussion" of e-Media's and NaviSite's "projected revenues." A931. Projections including e-Media's and Navisite's revenues were distributed to the Board ahead of the January 17, 2002 Board Meeting. A740; A943. Dwyer testified that "[Defendants] ended up making decisions upon" those projections. A746.

Critically, Defendants continued to put additional money into SMC through the Transactions, a decision that only makes sense based on the projections (and other contemporaneous valuations), and makes absolutely *no* sense under the negative valuation advanced by the Defendants for this litigation and adopted by the court. *See Gentile*, 2010 WL 2171613, at *10 ("The *most persuasive evidence* . . . that the Company's stock was worth considerably more . . . is [defendant's] *persistent willingness . . . to pour his ultimately limited resources into the Company*") (emphases added).

The management projections upon which Defendants relied, moreover, were created in a reliable manner and were consistent with industry trends. The projections were created through a reliable "bottoms-up" approach. A728-29; 61; AA861; A902-25. As the chart below illustrates, the trend in industry growth rates at the time of the Transactions was "consistently higher" than SMC's projected growth rate. A764; A1318; *see Global GT LP v. Golden Telecom, Inc.*, 993 A.2d 497, 502 (Del. Ch.), *aff'd*, 11 A.3d 214 (Del. 2010) (management projections were "reasonable when considering the trends in the . . . market generally, and the . . .

industry in particular”).



The Chancery Court should have “regarded with rightful suspicion attempts by [Defendants] who produced [projections based on the best judgment of management] to later disclaim their reliability, when that denial serves their litigation objective.” *Kessler*, 898 A.2d at 332. Moreover, Defendants—who bore the burden of proving the projections’ unreliability—*never* showed “deliberate attempt[s]” by management to “falsify [the] projected revenues and expenses,” *Gilbert*, 709 A.2d at 669, “unprecedented” use of the projections, or creation of projections “for the purpose of obtaining benefits outside the company’s ordinary course of business,” *Huff Fund*, 2013 WL 5878807, at *9.

The court therefore should have included the projections in its valuation. Instead, it disregarded them completely in favor of Defendants’ litigation-driven, backward-looking approach of applying a multiple to SMC’s last twelve months of revenue. Op. 108. But the court should not have valued SMC using only that method. Rather, as in prior Delaware cases, the court should have used these

projections of future earnings as indicators of value for SMC's start-up business in the nascent streaming media industry. *See TV58 Ltd. P'ship*, 1993 WL 285850, at *4; *Assoc'd Imports*, 1984 WL 19833, at *15-16.

Investors in the marketplace, like Defendants, invest in start-up companies not because of what they *have done*, but because of what they *may do*. The court erred when it limited valuation of start-up SMC in a budding industry to far less reliable backward-looking past revenues, particularly where contemporaneous management projections and methods for conducting forward-looking valuations existed, and Defendants themselves relied upon the projections. *See TV58 Ltd. P'ship*, 1993 WL 285850, at *4; *Assoc'd Imports*, 1984 WL 19833, at *15-16.

Unsurprisingly, the lone case that the court cited to support its application of a backward-looking methodology to SMC's start-up business did no such thing. To the contrary, the court in that case performed its own forward-looking DCF. *Compare* Op. 108 n.368 *with Golden Telecom*, 993 A.2d at 510. In fact, virtually all of the cases cited by the court relied upon a DCF or other forward-looking analysis, not a backward-looking analysis of the kind it adopted wholesale here.[8]

---

[8] *Henke v. Trilithic, Inc.*, 2005 WL 2899677, at *6-7 (Del. Ch. Oct. 28, 2005) (applying court's selected discount rate to management projections) (cited at Op. 105); *Emerging Commc'ns*, 2004 WL 1305745, at *12 (discounted cash flow) (cited at Op. 105); *Cede & Co. v. JRC Acquisition Corp.*, 2004 WL 286963, at *5 (Del. Ch. Feb. 10, 2004) (applying court's selected discount rate to management projections) (cited at Op. 105); *Cooper v. Pabst Brewing Co.*, 1993 WL 208763, at *10 (Del. Ch. June 8, 1993) (adopting assumptions of "a 3.0% return on sales and 1.5% annual sales volume growth") (cited at Op. 104); *Neal v. Ala. By-Prods. Corp.*, 1990 WL 109243, at *9 (Del. Ch. Aug. 1, 1990) (discounted future cash flow) (cited at Op. 103).

The court's rationale for disregarding the contemporaneous projections upon which Defendants relied in favor of their post hoc, backward-looking analysis fares no better. The court conceded "the inherent difficulty in valuing a start-up company in a nascent industry," Op. 107 n.363, and even espoused the view that "because the industry was so new and volatile, reliable projections were impossible," *id.* 104. But it nonetheless ignored the projections because it deemed them "wholly unreliable," *id.*, based on its hindsight view that SMC's management had "overestimated the Company's revenues" in the past, *id.* 106.

Yet SMC's contemporaneous projections were *made by a new management team* that Defendants hand-picked and had *not* been responsible for most of the projections that the court cited as evidence of unreliability. *Id.* 17. And the earlier projections did not somehow render any and all future projections unreliable—indeed, Defendants did not believe so at the time.

Critically, *none* of the cases that the court cited authorized it to substitute a hindsight view that the projections were unreliable for management's and *Defendants'* contrary, real-time determination of reliability that animated the Transactions. Two cases in which courts disregarded management projections are inapposite because management itself determined that the projections were unreliable. *See Doft & Co. v. Travelocity.com Inc.*, 2004 WL 1152338 (Del. Ch. May 20, 2004) (cited at Op. 104); *Kahn v. Household Acquisition Corp.*, 591 A.2d 166, 170 (Del. 1991) (cited at Op. 104). The third is even more inapposite: the

projections there were "not prepared in the ordinary course of business," and the court relied upon the "market price" of the company's shares "absent demonstration of self-dealing or a flawed sales process." *Huff Fund Inv.*, 2013 WL 5878807, at *1, *10 (cited at Op. 103-04). Here, the projections *were* prepared "in the ordinary course of business," there was no contemporaneous "market price" of the Company's shares, and the court expressly found that Defendants *had* engaged in "self-dealing [and] a flawed"—indeed, unfair—"sales process." *Id.*; *see also* Op. 1, 7, 119-23.

In all events, if Defendants had proven that the contemporaneous management projections upon which they relied were in fact unreliable, the court's wholesale disregard of the projections still would have been legal error. Delaware law makes clear that contemporaneous projections are such an integral indicator of value that courts may not disregard "unreliable" projections but, instead, should adjust them to offset any unreliability or management optimism. *See M.P.M. Enters., Inc. v. Gilbert*, 731 A.2d 790, 793 (Del. 1999) (affirming the Chancery Court's adjustment of management projections to account for actual results preceding the valuation date); *Henke*, 2005 WL 2899677, at *5, 6 (using "simple" projections that lacked "detail" and "provenance" as starting point in valuation) (cited at Op. 105); *Cede & Co. v. JRC Acquisition Corp.*, 2004 WL 286963, at *5 (Del. Ch. Feb. 10, 2004) (creating own projections due to "lack of definite, long-term management projections") (cited at Op. 105). This comports with industry

practice: in valuing start-up companies, an "appraiser, investment banker, or venture capitalist uses *the usually optimistic* forecast of the client-perhaps downplayed somewhat-and discounts that to present value *at a very high rate*, around 50% to 75%." Jay B. Abrams, Quantitative Business Valuation; a Mathematical Approach for Today's Professionals 514 (2d. ed. 2010) (emphases added). And this is *precisely what Plaintiffs' analysis did*. A972-1066.

Finally, in addition to directly and materially contributing to its unsupportable conclusion that "the equity value" of the Company was "$0," Op. 115, which manifestly contradicts Defendants' own actions at the time, the court's erroneous disregard of contemporaneous management projections improperly masked deficiencies in Defendants' proof. *All* of Defendants' fair price evidence rests on the premise that the projections should be excluded from any valuation of the Company despite Defendants' actual reliance on those projections. In fact, Defendants' expert performed only one valuation, which *excluded* both sets of projections. A1067. Defendants thus proffered no credible evidence to satisfy their fair price burden, and the court should have awarded at least $48.9 million in rescissory damages. *See* A586-87; A1270-71.

III. THE CHANCERY COURT ERRED IN FAILING TO AWARD DAMAGES ON PLAINTIFFS' DISCLOSURE CLAIM

A. Question Presented

Did the Chancery Court err by dismissing Plaintiffs' disclosure claim despite finding that Defendants' sole disclosure regarding the Transactions was "materially misleading," foreclosed Plaintiffs from exercising their contractual preemptive rights and from bringing a rescissory action in 2002, and severely hampered the fair price inquiry at trial? This question was preserved for appeal. A557-64.

B. Standard And Scope of Review

This Court reviews questions of law de novo. *Disney*, 906 A.2d at 48.

C. Merits of Argument

When corporate action is taken "by less than unanimous written consent," directors must provide stockholders who have not consented "[p]rompt notice of the taking of the corporate action." 8 *Del. C.* § 228(e). And "[w]henever directors communicate publicly or directly with shareholders about the corporation's affairs, with or without a request for shareholder action, [they] have a fiduciary duty . . . to exercise due care, good faith and loyalty," the "*sine qua non*" of which is "honesty." *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998). Once directors have "traveled down the road of partial disclosure," they have "an obligation to provide the stockholders with an accurate, full, and fair characterization." *Arnold v. Soc'y for Sav. Bancorp*, 650 A.2d 1270, 1280 (Del. 1994).

This Court applied these rules in *Lynch v. Vickers Energy Corp.*, where it

emphasized that the majority shareholder "owed a fiduciary duty to" minority stockholders "which required complete candor in disclosing fully all of the facts and circumstances surrounding the tender offer." 383 A.2d 278, 279 (Del. 1977). The Court therefore reversed the Chancery Court's judgment in favor of the defendants because they had failed to disclose a management valuation of assets and management's authorization of open market purchases of the target company's shares at a price above the challenged sale price. *Id.* at 279-81; *see also Arnold*, 650 A.2d at 1280 (reversing judgment where defendants made only "partial and incomplete disclosure[s]").

Here, Defendants made *no* disclosures to Plaintiffs or any minority stockholders prior to consummation of the Transactions. Their only disclosure was the post-Transaction Fall 2002 Update—which, the Chancery Court expressly found, failed to disclose "who participated in the [Transactions] and on what terms," and "was materially misleading and inconsistent with the Board's fiduciary duties." Op. 94; *see also id.* 122 (Defendants created an "informational vacuum"). Defendants then persisted in concealing their misconduct for *years*. The lengths to which they went in doing so itself reinforces the fact that they knew that the Transactions had not been set at a fair price. *See, e.g.*, *id.* 45 (refusing to disclose capitalization table because the requestor "would not be happy"). It also shows that Defendants intended to foreclose any attempt by Plaintiffs to investigate and understand the Transactions, negotiate over, or bring suit to enforce their rights—

including, in many cases, their preemptive rights—or take any other steps to respond to the self-dealing Transactions. Those are, of course, critical reasons why disclosure is required in the first place.

The court's findings establish a clear-cut disclosure violation. *See, e.g.*, *Arnold*, 650 A.2d at 1280; *Lynch*, 383 A.2d at 278-81. Thus, Plaintiffs are entitled to damages: "existing law and policy have evolved into a virtual *per se* rule of awarding damages for breach of the fiduciary duty of disclosure." *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1163 (Del. 1995).

Damages are warranted here not only under this *per se* rule, *see id.*, but also because Defendants' disclosure violation "logically and directly" harmed Plaintiffs, *In re Tyson Foods, Inc.*, 919 A.2d 563, 602 (Del. Ch. 2007). The disclosure violation was part of the Transactions that expropriated Plaintiffs' equity in SMC. But the harm from the disclosure violation was not limited to the Transactions that it helped to facilitate. Indeed, as the Chancery Court noted, the disclosure violation prevented Plaintiffs from "participat[ing] in the Recapitalization pro rata," Op. 129—even though twenty-two Plaintiffs held preemptive rights entitling them to an opportunity to do so and all Plaintiffs attested that "they were ready, willing, and able to provide additional capital" to SMC, *id.* 43. The disclosure violation also prevented Plaintiffs from bringing an action for rescission at the time of the Transactions, and prejudiced their litigation rights even in this suit because it created an "informational vacuum" that "severely

hampered" the evidentiary presentation at trial. *Id.* 118-19, 122.

These harms entitle Plaintiffs to damages on at least two separate measures. *First*, Defendants' active, years-long concealment and materially misleading Fall 2002 Update constitute a distinct violation of the duty of loyalty for which "harsher" remedies "designed to discourage disloyalty"—such as rescissory damages—"come into play." *Bomarko*, 766 A.2d at 441. Plaintiffs' rescissory damages for Defendants' egregious breaches amount to at least $48.9 million. A1270-71.

Second, as Plaintiffs attested, had they been made aware of Defendants' actions in 2002, they would have brought an action for rescission, enforced their contractual preemptive rights, and invested in SMC themselves. Op. 43. The Chancery Court has already determined that an appropriate award for the "consideration [Plaintiffs] would have received in the Akamai Merger had they participated in the Recapitalization pro rata . . . would be approximately $17.8 million, plus interest." *Id.* 129. At the very least, Plaintiffs are entitled to damages in this amount. *See, e.g.*, *Cinerama, Inc.*, 663 A.2d at 1163.

The Chancery Court, however, rejected the disclosure claim in a one-sentence footnote. Op. 93 n.325. But neither of its proffered rationales withstands even minimal scrutiny. First, the Chancery Court reasoned that "[b]ecause the Plaintiffs have not demonstrated that the Fall 2002 Update harmed them separate from the overall Recapitalization, the Court considers their contentions about the

Board's inadequate disclosures in the context of the entire fairness analysis." *Id.* The court's premise, however, is legally flawed. Plaintiffs had *no* obligation to prove harm "separate from" the Transactions, only harm "aris[ing] logically and directly from the lack of disclosure." *Tyson Foods*, 919 A.2d at 602. Damages must flow from the legal violation proven, *In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 766 (Del. 2006), but that does not mean, as the court held, that a plaintiff must prove distinct or different damages on every claim.

In all events, Plaintiffs *did* prove harm "separate from" the Transactions in the form of the violation of their preemptive rights and the delay and prejudice to their litigation rights. *See, e.g.*, Op. 43, 118-19, 122, 129. The court therefore erred in holding that Defendants' disclosure violation was subsumed by the entire fairness inquiry. *See id.* 93 n.325.

The court also reasoned that Plaintiffs' loss of the opportunity to "participate[] in the [purchase of new B-1 stock] pro rata," which damaged them by "approximately $17.8 million, plus interest," was not actionable because "Defendants were under no duty to allow the Plaintiffs to participate." *Id.* 129-30. But the court acknowledged that Plaintiffs had contractual preemptive rights, including the right to participate pro rata, *see id*. 29 n.100; 83—and those rights imposed a corresponding "duty" on Defendants "to allow the Plaintiffs to participate" in the Transactions, *id.* 129–30. This Court should reverse the rejection of Plaintiffs' disclosure claim and enter an award of damages.

IV. DEFENDANTS OWED FIDUCIARY DUTIES TO PREFERRED A STOCKHOLDERS

A. Question Presented

Did the Chancery Court err by holding that Preferred A Plaintiffs, who converted notes into equity as a necessary precursor to the Transactions, lacked standing? This question was preserved for appeal. A184-87.

B. Standard And Scope of Review

This Court reviews a grant of summary judgment de novo. *Emerald Partners v. Berlin*, 726 A.2d 1215, 1219 (Del. 1999).

C. Merits of Argument

When the holder of a debenture converts that instrument into equity, she becomes a shareholder and exchanges her contractual protections for fiduciary protections. *See, e.g.*, *Simons v. Cogan*, 549 A.2d 300, 303-04 (Del. 1988) ("*Until the debenture is converted into stock* the convertible debenture holder acquires no equitable interest . . . .") (emphasis added)). The Preferred A Plaintiffs made such a conversion by May or June 2002 when they executed the Subscription and Surrender Agreements. *See* A198-254. With these agreements, the Preferred A Plaintiffs *irrevocably* altered the character of their investments, A202, and "surrender[ed] for cancellation all of the Senior Secured Notes . . . issued to him/her by the Company," A200. They also relinquished all contractual protections, forfeited their warrants to purchase common stock, and their notes stopped accruing interest as of May 15, 2002. A200-02. From that point onward,

their interest in SMC was entirely beholden to the decisions of SMC's Board of Directors. *See* A198-254. In short, they subjected themselves to the economic risks of stock ownership and received an equitable interest with fiduciary protection in return. *See* A200-02; *Simons*, 549 A.2d at 304.

The Chancery Court nonetheless held that the Preferred A Plaintiffs lacked standing because *Defendants* chose to issue the shares simultaneously with the final step of the Transactions. SJ Op. 19-20. The court rested that holding on an erroneous understanding of this Court's decisions in *Simons* and *Anadarko*. In *Simons*, Plaintiffs were dismissed because they *had not converted* their debt to equity. 549 A.2d at 304. Here, in executing the Subscription and Surrender Agreements, Preferred A holders had effectively converted, irrevocably given up their "entitlement to legal protections," and "assumed the risk of stockholder status."[9] In *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, prospective stockholders challenged contractual renegotiations undertaken prior to share issuance. 545 A.2d 1171 (Del. 1988). This Court held that these prospective stockholders had no standing because the challenged actions happened prior to their becoming stockholders. *Id.* But here, the Preferred A Plaintiffs challenge actions taken subsequent to their agreement to convert and commensurate with

[9] In dismissing, the Chancery Court cited Justice Holmes' statement that "the holder of a convertible bond is and only is a corporate creditor to whom contractual but not fiduciary duties are owed *unless he acts to end his entitlement* to the legal protections his contract affords him *and to assume the risks of stockholder status* through exercise of the power of conversion." *Simons*, 542 A.2d at 791 (emphasis added).

their share issuance. *Id.* 19-20. Indeed, the Preferred A conversion was a "necessary precursor" of the challenged transactions here. *Id.* 10. The Preferred A Plaintiffs thus became stockholders before the Transactions were completed, and Defendants violated their fiduciary duties by secretly diluting this newly-acquired equity and then concealing that dilution for years.

The court's decision rewards the Defendants' self-dealing and erroneously prevents a class of stockholders from challenging a "grossly unfair" set of Transactions.[10] Moreover, the cases the court cited reflect Delaware law's rejection of the "evil" of purchasing stock to then challenge a transaction.[11] That policy, however, is in no way implicated here because the Preferred A Plaintiffs already owned an interest in SMC and irrevocably agreed to convert their debt to equity as a precursor to the Transactions.

---

[10] Defendants did not offer the Preferred A Plaintiffs participation in any of the other transactions that comprised the Transactions, including the Preferred B-1 stock; did not inform them of the terms of those transactions, including the price; did not inform them that Fund Defendants Wren and Javva were the sole recipients of the Preferred B-1; and did not inform them that the Transactions extracted and expropriated almost all of the equity and voting power of the minority stockholders. A270 (Wien testifying that he was not offered a further opportunity to invest); A263 (Rausman testifying to same); A258 (Fuchs testifying that Hsu was not offered a further opportunity to invest).

[11] *See, e.g.*, *Omnicare, Inc. v. NCS Healthcare, Inc.*, 809 A.2d 1163, 1169 (Del. Ch. 2002) (discussing Delaware's "longstanding" public policy against purchasing a lawsuit); *IM2 Merchandising & Mfg., Inc. v. Tirex Corp.*, 2000 WL 1664168, at *6 (Del. Ch. Nov. 2, 2000) (dismissing claim based on continuous ownership rule).

V. THE COURT MISCALCULATED ATTORNEYS' FEES AND COSTS

A. Question Presented

Did the Chancery Court err in miscalculating attorneys' fees and costs when it relied upon faulty valuation principles in its novel litigation-recovery-range analysis? This question was preserved for appeal. A663-64; A670.

B. Standard And Scope of Review

This Court reviews awards of attorneys' fees for abuse of discretion. *Sugarland Indus., Inc. v. Thomas*, 420 A.2d 142, 149 (Del. 1980).

C. Merits of Argument

The Chancery Court correctly held that an award of attorneys' fees was appropriate due to Defendants' "bad faith" and "grossly inadequate process." Att'y Fees Op. 5-6. Plaintiffs were entitled to "all of their attorneys' fees" due to Defendants' "breach[es] of fiduciary duty." *Saliba v. William Penn P'ship*, 2010 WL 1641139, at *1 (Del. Ch. Apr. 12, 2010), *aff'd*, 13 A.3d 749 (Del. 2011).

But the court declined to award the entire $11,427.195.23 incurred, instead entering an award of $2 million. Att'y Fees Op. 11. The court rested this steep reduction on "an amalgam of plausible pre-trial expectations, discounting for litigation uncertainty and the particular risk of this proceeding, and interest" that, in its view, should have informed counsel's expectations of recovery. *Id.* 11 & n.31. The court determined that it would award fees on a "more realistic benchmark of a $7-10 million" in damages that Plaintiffs could have expected. *Id.* This novel litigation-recovery-range method is legally erroneous for two reasons.

First, Delaware law prescribes a quantum meruit measure of attorneys' fees where the benefit conferred is not quantifiable, as it is in the absence of a damages award. Att'y Fees Op. 10.[12] There is no reason to replace that established method with a novel approach that rests primarily on counterfactual hindsight into what Plaintiffs' counsel might have expected had it known the end from the beginning, especially given the contemporaneous valuations and projections that existed here, and Defendants' misconduct. *Second*, the court's method relies upon the same faulty valuation principles that plagued its fair price analysis. The court asserted, for example, that there was "some support" for an expected recovery of approximately $10 million, Att'y Fees Op. 8, but this calculation takes no account of the *five* contemporaneous valuations or any management projections.

Even if the rejection of those projections in the entire fairness context were correct, the court's fee award method fails, as it effectively held that Plaintiffs and their counsel were unreasonable to rely on the very projections Defendants relied on at the time. And any lack of other contemporaneous data—*e.g.*, of independent advice—arose from the "grossly unfair" process that "severely hampered" the valuation presentation. Op. 118-19. The court's method again allowed Defendants to escape their burden and the consequences of their misdeeds and prescribes

[12] *See also In re Dunkin' Donuts S'holders Litig.*, 1990 WL 189120, at *8 (Del. Ch. Nov. 27, 1990); *Sugarland*, 420 A.2d at 149; *Seinfeld v. Coker*, 847 A.2d 330, 333 (Del. Ch. 2000). To the extent this Court holds that damages should be awarded to Plaintiffs, the Chancery Court should reconsider its fee award with appropriate guidance from this Court.

reversal.

CONCLUSION

This Court should reverse the Chancery Court's damages ruling and dismissal of the claims of Preferred A stockholders and alter its attorneys' fees ruling.

<u>/s/ Anne C. Foster</u>
Anne C. Foster (#2513)
Blake Rohrbacher (#4750)
Susan M. Hannigan (#5342)
RICHARDS, LAYTON & FINGER, P.A.
One Rodney Square
920 N. King Street
Wilmington, DE 19801
(302) 651-7700

Attorneys for Plaintiffs-Below/Appellants

OF COUNSEL:

Lawrence D. Rosenberg
John M. Gore
Sarah A. Hunger
JONES DAY
51 Louisiana Avenue, N.W.
Washington, D.C. 20001
(202) 879-7622

Dated: July 23, 2015