2017 WL 1437308
Court of Chancery of Delaware.

The FREDERICK HSU LIVING TRUST, Plaintiff,
v.
ODN HOLDING CORPORATION, Oak Hill Capital Partners III, L.P., Oak Hill Capital Management Partners III, L.P., OHCP GenPar III, L.P., OHCP MGP Partners III, L.P., OHCP MGP III, Ltd., Robert Morse, William Pade, David Scott, Debra Domeyer, Jeffrey Kupietzky, Allen Morgan, Lawrence Ng, Scott Jarus, Kamran Pourzanjani, Elizabeth Murray, Tood H. Greene, and Scott Morrow, Defendants.

C.A. No. 12108–VCL
|
Submitted: January 31, 2017
|
Decided: April 14, 2017
|
Corrected: April 24, 2017

MEMORANDUM OPINION

LASTER, Vice Chancellor

***1** In 2008, funds sponsored by the venture capital firm Oak Hill Capital Partners invested $150 million in Oversee.net, a California corporation. To facilitate the investment, the parties formed ODN Holding Corporation (the “Company”) as a holding company for Oversee.net. In return for its cash, Oak Hill received shares of Series A Preferred Stock (the “Preferred Stock”) from the Company. Oak Hill had the right to require the Company to redeem its Preferred Stock in 2013.

In 2009, Oak Hill became the Company’s controlling stockholder. Initially, little changed. The Company continued to expand through acquisitions and reinvested its capital for growth. Then, in 2011, the Company switched into liquidation mode. It stopped investing for growth, sold two of its four lines of business, and hoarded the resulting cash. When Oak Hill exercised its redemption right in 2013, the Company used as much of its cash as possible for redemptions. When that wasn’t enough to redeem the Preferred Stock in full, the Company sold its third line of business and used the resulting cash for more redemptions. The process turned a once-promising company into a shell of its former self.

Frederick Hsu—one of the Company’s founders—brought this action against Oak Hill, the Company’s board of directors (the “Board”), and certain of the Company’s officers. His

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complaint ... contends that the individual defendants and Oak Hill breached their duty of loyalty by seeking in bad faith to benefit Oak Hill by maximizing the value of Oak Hill's redemption right, rather than by striving to maximize the value of the corporation over the long-term for the benefit of the undifferentiated equity. ...

The Complaint states a claim for breach of the duty of loyalty against Oak Hill and all but one of the individual defendants. The Complaint's detailed factual allegations support a reasonable inference that the individual defendants acted in bad faith to benefit Oak Hill by maximizing the value of its contractual redemption right, and the actions of Oak Hill's representatives are attributable to Oak Hill. The allegations support a reasonable inference that the entire fairness standard will apply and that the defendants will be unable to show that their course of conduct was entirely fair. The motions to dismiss the fiduciary duty claims are granted in one respect: defendant Kamran Pourzanjani is dismissed because it is not reasonably conceivable that he will not be entitled to exculpation.

...

I. FACTUAL BACKGROUND

The facts for purposes of the motions to dismiss are drawn from the well-pled allegations of the Verified Class Action and Derivative Complaint (the "Complaint") and the documents it incorporates by reference. At this stage, the allegations of the complaint are assumed to be true, and the plaintiff receives the benefit of all reasonable inferences.

...

A. A Growing Company

Hsu and Lawrence Ng co-founded Oversee.net in 2000. Under their stewardship, Oversee became a "leading provider of technology-based marketing solutions to online publishers and advertisers worldwide." By 2007, the Company's annual revenue exceeded $200 million and its net income exceeded $19 million. At that point, the Company had four lines of business:

- Domain Monetization Services. This business drove Internet traffic derived from the Company's network of owned and managed domain names to online advertisers.
- Vertical Markets. This business provided marketers with leads from personal information collected by the Company's websites.
- Domain Aftermarket Services. This business sold domain names predominantly for third parties.
- Domain Registrar Services. This business charged fees for domain name registration and

ancillary services.

Oversee grew internally by developing its own products and externally through acquisitions. During the eighteen-month period leading up to December 2007, Oversee made five acquisitions....

B. Oak Hill Invests $150 Million.

In February 2008, Oak Hill invested $150 million in Oversee. The parties formed a new Delaware corporation—the Company—to facilitate the transaction. Oversee became its wholly owned subsidiary. In return for its cash, Oak Hill received 53,380,783 shares of Preferred Stock.

The terms of the Preferred Stock gave Oak Hill the ability to exercise a mandatory redemption right beginning five years after its investment. ... If the Company did not have sufficient funds to redeem the Preferred Stock, then the terms of the Preferred Stock contemplated ongoing redemptions as funds became available. ....

This decision refers to Oak Hill's right to cause the Company to redeem the Preferred Stock as the "Redemption Right." It refers to the provisions that governed the redemption of the Preferred Stock collectively as the "Redemption Provisions."

C. Oak Hill Becomes The Company's Controlling Stockholder.

Oak Hill started as a minority investor. The Preferred Stock did not carry a majority of the Company's voting power, and Oak Hill only had the right to fill two seats on a seven-member Board. The Company's certificate of incorporation called for (i) two seats elected by the holders of the Preferred Stock voting as a separate class, (ii) three seats elected by the holders of the common stock voting as a separate class, and (iii) two seats elected by the holders of common stock and the Preferred Stock voting together. Oak Hill filled its two positions with Robert Morse, the Oak Hill partner who sponsored the investment, and William Pade, another Oak Hill partner.

***5** In 2009, Oak Hill paid $24 million to purchase enough shares of common stock from Ng to give Oak Hill control over a majority of the Company's voting power. After Oak Hill acquired mathematical control, the Board was enlarged to eight members, and a third Oak Hill representative—David Scott—became a director. Scott was an Oak Hill vice president. This decision refers to Morse, Pade, and Scott as the "Oak Hill Directors."

The other five Board members were Jeffrey Kupietzky, Ng, Allen Morgan, Scott Jarus, and Kamran Pourzanjani. Kupietzky served as the Company's President and Chief Executive Officer. The others were non-management directors, but the Complaint strives to paint them in hues of gray. The Complaint alleges that Ng now felt indebted to Oak Hill for paying him $24 million to purchase a substantial block of his otherwise illiquid common stock. The Complaint

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observes that Morgan worked for fifteen years as a corporate attorney with Wilson Sonsini Goodrich & Rosati, LLP, Oak Hill's current and long-time counsel. Morgan also served alongside Pade on the board of another company, and the two men had an ongoing social relationship through their sons, who were friends. The Complaint alleges that Morgan, Jarus, and Pourzanjani served regularly on boards of Silicon Valley companies, and this made them want to remain on good terms with Oak Hill because of its outsized influence within the highly networked Silicon Valley community.

Oak Hill's acquisition of majority control did not immediately result in any change in the Company's business strategy. For the next two years, the Company continued to focus on growth. ...

D. Oak Hill Changes The Company's Strategy.

The Complaint alleges that at some point during 2011, Oak Hill concluded that "exercising its contractual redemption right in February 2013 was the most effective way to achieve the return of its capital." Compl. ¶ 35. The Complaint alleges that beginning in 2011, Oak Hill caused the Company to alter its business plan by no longer focusing on growth, whether internally or by acquisition, and instead seeking to accumulate cash that could be used for redemptions.

Consistent with a directional reset, the Company changed its management team in mid–2011. In June 2011, defendant Scott Morrow became co-President alongside Kupietzky. In August 2011, Kupietzky left the Company. Defendant Debra Domeyer, who had been serving as the Company's Chief Technology Officer, became co-President with Morrow. In December 2011, one of the Company's outside directors—Pourzanjani—left the Board. His seat remained vacant.

Also consistent with a directional reset, the Company did not make any acquisitions during 2011. By the end of the year, the Company's cash reserves had nearly doubled, from $13.2 million at the end of 2010 to $23.7 million at the end of 2011.

Most significantly, the Company spent the second part of 2011 preparing to sell two of its four lines of business: the Domain Aftermarket Services business and the Domain Registrar Services business. The Company completed the sale in January 2012 for total proceeds of $15.4 million. The Company had paid more than $46.5 million in 2007 to purchase two of the companies that comprised just part of the divested lines of business. Five years later, the Company sold the two lines of business in their entirety for a third of the price. The sale of the two lines of business had a dramatic effect on the Company's revenue-generating capacity. Total annual revenue dropped from $141 million in 2011 to $89 million in 2012.

E. Further Moves In Preparation For Redemption

***6** In May 2012, Domeyer became the Company's CEO and joined the Board. Pourzanjani was

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not replaced, so the Board had seven directors: the three Oak Hill Directors, Domeyer, Morgan, Jarus, and Ng.

Pade and Ng were the members of the Compensation Committee. In May 2012, they approved bonus agreements for Domeyer and two of the Company's senior officers: Elizabeth Murray, the Chief Financial Officer, and Todd Greene, the General Counsel. The agreements provided for special payments if the Company achieved a "liquidity event," defined to include the redemption of at least $75 million of Preferred Stock.

In 2012, the Company again did not make any acquisitions. By the end of the year, the Company's cash reserves had doubled a second time. At the end of 2011, the Company had $23.7 million in cash. By the end of 2012, it had $50 million. This was more than three times the Company's average end-of-year cash balance of $15.5 million during the period from 2007 to 2010, when the Company was in growth mode.

F. The Committee

In August 2012, with the Redemption Right looming, the Board formed a special committee (the "Committee") charged with evaluating the Company's alternatives for raising capital for redemptions and to negotiate with Oak Hill over the terms of any redemptions. The resolution creating the Committee provided that the Board would not approve any transaction relating to the Redemption Right without a prior favorable recommendation from the Committee. The resolution provided that the Committee's authority would terminate when Oak Hill exercised the Redemption Right.

The members of the Committee were Morgan and Jarus. The Committee held its first meeting on August 28, 2012. Morgan disclosed his social relationship with Pade. He did not disclose his service with Pade on another board or his relationship with Oak Hill through his work at Wilson Sonsini.

G. The Officers' Recommendation

In September 2012, the Committee tasked Domeyer, Murray, and Greene—the three officers with bonuses tied to redemptions—with creating a proposal for Oak Hill. The officers determined that the Company only needed a cash reserve of $10 million, or one-fifth of the amount it had accumulated. This freed $40 million for other uses. The officers proposed that the Company use all of it redemptions, borrow an additional $35 million, and use all of that for redemptions as well. The total of $75 million would result in the Company redeeming half of the shares of the Preferred Stock, which had a contractual value of $150 million in the aggregate for purposes of redemptions. It also would trigger the officers' bonuses.

The officers worried that banks would not lend to the Company if they perceived that additional funds would be funneled to Oak Hill, so the officers proposed that the $75 million redemption

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be conditioned on Oak Hill not receiving any further redemptions until 2017. In October 2012, the Committee adopted the general framework of the recommendation but shortened the delay on further redemptions from 2017 until 2016.

Oak Hill rejected the proposal. Oak Hill countered by asking that the Company agree to redeem additional shares of Preferred Stock if the Company sold assets. Oak Hill also wanted a cumulative dividend of 12% per annum paid in kind on the unredeemed shares. The terms of the Preferred Stock did not give Oak Hill the right to a cumulative dividend, before or after the exercise of the Redemption Right. The terms of the Preferred Stock also recognized that the Company only was obligated to redeem as many shares of Preferred Stock as it could out of legally available funds and after that, the Board only had to generate funds for further redemptions consistent with its fiduciary duties. During the time it took to generate additional funds, Oak Hill was not entitled to any increase in the redemption price and had no other remedies. Oak Hill's request would cause the balance of the redemption obligation to compound at 12% per annum.

***7** The Committee did not accept Oak Hill's counter. In November 2012, the Committee proposed that 100% of the net cash proceeds from any divestures outside the ordinary course of business would go towards redemptions and that Oak Hill would receive a 2% cumulative payment-in-kind dividend on any shares of Preferred Stock that were not redeemed. In return for these concessions, the Committee proposed that the Company would not make any additional redemptions until 2015.

Concurrently, Murray contacted several banks about a credit facility. Because the borrowings would be used for redemptions, only one bank would even consider a loan. That bank conditioned its proposal on Oak Hill guaranteeing repayment. Oak Hill refused. The bank then offered a two-year term loan of $15 million, conditioned on the Company *not* using any of the proceeds for redemptions. The inability to secure financing prevented the Company from using debt to redeem a portion of the Preferred Stock, as the officers had proposed, and thereby hit the $75 million trigger for their bonuses.

H. Oak Hill's Demand And The Officers' Revised Recommendation

On February 1, 2013, Pade told the Committee that Oak Hill intended to exercise the Redemption Right in full on the earliest possible date, *i.e.* February 13. Acknowledging that the Company did not have the funds to redeem the Preferred Stock in full, Pade proposed that the Company immediately make a redemption payment of $50 million, which he later reduced to $45 million. In return, Oak Hill would forbear on receiving further redemption payments until December 31, 2013. Under Pade's proposal, Oak Hill would have the right to cancel the forbearance agreement unilaterally and demand additional redemptions on thirty-days' notice.

On February 12, 2013, the Committee met to consider Pade's demand. One obvious problem

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was that using $45 million for redemptions would leave the Company with only $5 million in cash, which was half of the reserve of $10 million in cash that the officers had stated was necessary to support the Company's operations. During the period from 2007 to 2010, the Company ended each year with an average of $15.5 million in cash.

Conveniently, the officers changed their minds about how much cash the Company needed. Murray advised the Committee that she now believed $2 million in cash was sufficient. That figure permitted the Company to make the $45 million redemption payment that Oak Hill wanted.

The Committee did not seek any other changes in Oak Hill's proposal, such as more meaningful forbearance. Under Oak Hill's proposal, the thirty-day termination right rendered the forbearance offer largely illusory. Moreover, the offer at most contemplated forbearance of ten months. This was effectively the sleeves from Oak Hill's vest, because (i) Oak Hill had no ability to compel the Company to make redemptions except out of legally available funds, (ii) the Board had the right to determine how to raise additional funds in a manner that complied with its fiduciary duties, and (iii) one can readily doubt whether, after a $45 million redemption, the Company would have the capacity to make any additional redemptions during the remaining nine months of the year.

But the Committee did not push back. They resolved to recommend that the Board accept Oak Hill's terms.

I. The March Redemption

On February 13, 2013, Oak Hill exercised the Redemption Right in full and on the earliest possible date. In accordance with Generally Accepted Accounting Principles ("GAAP"), the Company reclassified Oak Hill's Preferred Stock as a current liability on its balance sheet in the amount of $150 million. The Committee's authority terminated with the exercise of the Redemption Right.

***8** On February 27, 2013, the Board met to consider Oak Hill's demand for redemption. ... Domeyer, Morgan, Jarus, and Ng voted to approve the redemption. The Oak Hill Directors abstained. On March 18, 2013, the Company paid Oak Hill $45 million to redeem shares of Preferred Stock (the "March Redemption"). Although Kupietzky was no longer employed by the Company, his employment agreement called for him to receive a bonus if shares of Preferred Stock were redeemed. He received $632,813, or approximately 1.4% of the redemption amount. Murray, Greene, and Domeyer did not receive a bonus, because their agreements required a redemption of at least $75 million to trigger their payments.

...In September 2013, Morse left Oak Hill and resigned from the Board. This left Pade and Scott as the Oak Hill representatives. Morse's seat was left vacant.

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J. The September Redemption.

In February 2014, Domeyer advised the Board that a strategic acquirer had expressed interest in purchasing the Domain Monetization business. After selling two lines of business in January 2012, the Company had two lines left. The Domain Monetization business was the Company's primary source of revenue.

Recognizing that any cash generated by the sale could be used for redemptions, and perceiving that this could create a conflict for the Oak Hill Directors, the Board reconstituted the Committee to oversee the negotiations. Its members again were Morgan and Jarus. The Committee delegated the actual negotiations to Domeyer, Murray, and Greene, the three members of management with bonuses tied to achieving $75 million in redemptions.

In April 2014, management reached an agreement to sell the Domain Monetization business for $40 million. The Committee recommended the deal to the Board, and the Board approved it on April 14.

The sale of the Domain Monetization business closed in May 2014. The Board moved quickly to deploy the resulting cash for redemptions. On June 4, the Board acted by written consent to reconstitute the Committee a third time, once again consisting of Morgan and Jarus, and charged the Committee with overseeing the redemption process.

The Board also decided to free up additional cash for redemptions through a restructuring. It would involve terminating certain executives, reducing the overall work force, and terminating the Company's lease on its Los Angeles headquarters. The Board charged the Committee with implementing the restructuring.

***9** The Committee delegated the details of both tasks to Domeyer, Murray, and Greene. In July 2014, the officers presented a plan for the restructuring. The Committee rejected it because it did not cut costs enough. The Committee told the officers to cut more.

On August 4, 2014, the officers presented a revised plan. The Committee rejected it and told the officers to cut more.

On August 25, 2014, the full Board received an update on the Committee's work. The officers recommended a business plan that involved greater cost reductions and the sale of one of the three segments of the Company's lone remaining line of business, Vertical Markets. The full Board approved the new business plan with Pade, Scott, Domeyer, Morgan, and Jarus voting in favor. Ng abstained.

On August 29, 2014, the Committee determined that in light of the new business plan, the Company could make a redemption payment of $40 million to Oak Hill. The Committee resolved to ask Oak Hill to extend the forbearance agreement until March 31, 2015. One can

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readily question whether this term provided any benefit to the Company, because after a $40 million redemption, it was doubtful that the Company would have the capacity to redeem any additional shares during the next seven months.

The full Board met on September 2, 2014. The Board determined that the Company had sufficient surplus to make a redemption payment of $40 million. As before, the Board did not treat Oak Hill's remaining Preferred Stock as a current liability of $105 million, as it appeared on the Company's balance sheet. The Board approved the redemption payment on the terms recommended by the Committee, and the Company made the redemption (the "September Redemption").

The Company previously had redeemed $45 million in Preferred Stock through the March Redemption. The September Redemption brought the total to $85 million. That amount exceeded the $75 million redemption trigger for the officers' bonuses. Domeyer, Murray, and Greene each received a bonus of $587,184.

K. One More Divestiture

The sale of the Domain Monetization business left the Company with only its Vertical Markets line of business. It had three segments: Retail, Travel, and Consumer Finance. Retail generated nearly half of the Company's remaining revenue. The "crown jewel" of Retail was Shopwiki. In 2010, the Company acquired Shopwiki for $17 million. In December 2014, the Company sold Shopwiki for $600,000.

The sale of Shopwiki capped a remarkable period during which the Company sold three of its four lines of business in their entirety and divested the principal economic driver of the fourth line of business. The sales had a dramatic effect on the Company's cash-generating capacity. In 2011, before the divestitures, the Company generated annual revenue of $141 million. In 2015, after the divestitures, the Company generated annual revenue of $11 million, a decline of 92%.

On October 19, 2015, Ng left the Board. His seat remained vacant. The current Board comprises Pade, Scott, Domeyer, Morgan, and Jarus.

L. This Litigation

... ***10** On March 15, 2016, Hsu filed this action through his living trust, which holds his Company stock. The defendants have moved to dismiss the Complaint.

II. RULE 12(b)(6) ANALYSIS

The defendants have moved to dismiss the Complaint pursuant to Rule 12(b)(6) for failing to state a claim on which relief can be granted. When considering such a motion,

> (i) all well-pleaded factual allegations are accepted as true; (ii) even vague allegations are

> well-pleaded if they give the opposing party notice of the claim; (iii) the Court must draw all reasonable inferences in favor of the non-moving party; and (iv) dismissal is inappropriate unless the plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances susceptible of proof.

Savor, Inc. v. FMR Corp., 812 A.2d 894, 896–97 (Del. 2002) (footnotes and internal quotation marks omitted).

...

B. The Claim For Breach Of Fiduciary Duty Against The Directors

Count I of the Complaint alleges that the directors breached their fiduciary duties by "abandoning the Company's growth strategy which was benefitting its common stockholders in favor of selling off whole business lines and hoarding cash in order to provide the maximum amount Oak Hill could extract non-ratably from the Company by exercising its redemption right." Compl. ¶ 124. Analyzing this claim requires working through the standard of conduct, applying a standard of review, and then determining whether the defendants have properly invoked any immunities or defenses, such as exculpation.

"When determining whether directors have breached their fiduciary duties, Delaware corporate law distinguishes between the standard of conduct and the standard of review." [*Chen v. Howard Anderson*, 87 A.3d 648, 666 (Del. Ch. 2014).] "The standard of conduct describes what directors are expected to do and is defined by the content of the duties of loyalty and care. The standard of review is the test that a court applies when evaluating whether directors have met the standard of conduct." *Trados II*, 73 A.3d at 35–36. For the reasons that follow, the Complaint adequately pleads conduct that implicates the duty of loyalty, the standard of review for evaluating whether a breach occurred is the entire fairness test, and the Complaint sufficiently pleads that the actions taken by the defendant directors were unfair.

1. The Standard of Conduct

***16** Delaware corporate law starts from the bedrock principle that "[t]he business and affairs of every corporation ... shall be managed by or under the direction of a board of directors." 8 *Del. C.* § 141(a). "A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation." [*Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).] "The existence and exercise of [the board's authority under Section 141(a)] carries with it certain fundamental fiduciary obligations to the corporation and its shareholders." *Aronson*, 473 A.2d at 811.

Directors of a Delaware corporation owe two fiduciary duties—care and loyalty. "[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally." *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

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Corporate fiduciaries "are not permitted to use their position of trust and confidence to further their private interests." *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

The duty of loyalty includes a requirement to act in good faith, which is "a subsidiary element, *i.e.*, a condition, of the fundamental duty of loyalty." *Stone*, 911 A.2d at 370 (internal quotation marks omitted). "A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation." [*In re Walt Disney Co. Deriv. Litig.* (*Disney II*), 906 A.2d 27, 67 (Del. 2006).]

***17** In the standard Delaware formulation, fiduciary duties run not only to the corporation, but rather to the corporation and its shareholders. The conjunctive expression "captures the foundational relationship in which directors owe duties to the corporation for the ultimate benefit of the entity's residual claimants." *Trados II*, 73 A.3d at 36–37. "It is, of course, accepted that a corporation may take steps, such as giving charitable contributions or paying higher wages, that do not maximize corporate profits currently. They may do so, however, because such activities are rationalized as producing greater profits over the long-term." [Footnote omitted] Decisions of this nature benefit the corporation as a whole, and by increasing the value of the corporation, the directors increase the quantum of value available for the residual claimants. Nevertheless, "Delaware case law is clear that the board of directors of a for-profit corporation ... must, within the limits of its legal discretion, treat stockholder welfare as the only end, considering other interests only to the extent that doing so is rationally related to stockholder welfare." [Footnote omitted]

Consequently, under Delaware law, for directors to act loyally to advance the best interests of the corporation means that they must seek "to promote the value of the corporation for the benefit of its stockholders." [*eBay Domestic Hldgs., Inc. v. Newmark*, 16 A.3d 1, 34 (Del. Ch. 2010).] In a world with many types of stock—preferred stock, tracking stock, common stock with special rights, common stock with diminished rights (such as non-voting common stock), plain vanilla common stock, *etc.*—and many types of stockholders—record and beneficial holders, long-term holders, short-term traders, activists, momentum investors, noise traders, *etc.*—the question naturally arises: which stockholders? The answer is the stockholders in the aggregate in their capacity as residual claimants, which means the undifferentiated equity as a collective, without regard to any special rights.[16]

***18** A Delaware corporation, by default, has a perpetual existence. 8 *Del. C.* §§ 102(b)(5), 122(1). Equity capital, by default, is permanent capital. In terms of the standard of conduct, therefore, the fiduciary relationship requires that the directors act prudently, loyally, and in good faith to maximize the value of the corporation over the long-term for the benefit of the providers of presumptively permanent equity capital, as warranted for an entity with a presumptively perpetual life in which the residual claimants have locked in their investment.

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The fact that shares are alienable by default, *see* 8 *Del. C.* § 202, does not alter the presumptively permanent nature of equity capital. Alienability ameliorates the effects of capital lock-in by enabling an individual holder to exit via sale, but it does not permit the capital to be removed from the entity. Selling simply substitutes a new owner as the holder of the bundle of rights associated with the equity. The capital remains locked in.

***19** The fact that some holders of shares might be market participants who are eager to sell and would prefer a higher near-term market price likewise does not alter the presumptively long-term fiduciary focus. "The duty to act for the ultimate benefit of stockholders does not require that directors fulfill the wishes of a particular subset of the stockholder base."[19] Directors need not seek to maximize current market value for the benefit of the subset of stockholders who hope to sell in the near term and capture capital gains from the trade.

It also bears emphasizing that a duty to maximize long-term value does not always mean acting to ensure the corporation's perpetual existence. A fiduciary might readily determine that a near-term sale or other shorter-horizon initiative, such as declaring a dividend, is value-maximizing even when judged against the long-term. A trade bidder with access to synergies, for example, may offer a price for a corporation beyond what its standalone value could support. Or fiduciaries might conclude that continuing to manage the corporation for the long-term would be value destroying because of external market forces or other factors. The directors who managed the proverbial maker of horse-and-buggy whips would have acted loyally by selling to a competitor before the new-fangled horseless carriage caught on. Writing as a Vice Chancellor, Chief Justice Strine provided an example in the extreme case of insolvency, explaining that the value-maximization mandate may require directors to favor liquidation over continuing the business:

> The maximization of the economic value of the firm might ... require the directors to undertake the course of action that best preserves value in a situation when the procession of the firm as a going concern would be value-destroying. In other words, the efficient liquidation of an insolvent firm might well be the method by which the firm's value is enhanced. ... [*Prod. Res. Gp., L.L.C. v. NCT Gp., Inc.*, 863 A.2d 772, 791 n.60 (Del. Ch. 2004).]

***20** The same is true for a solvent corporation. "[D]irectors, generally, are obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon." *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1989). What the fiduciary principle requires in every scenario is that directors strive to maximize value for the benefit of the residual claimants.

***21** Directors must exercise independent fiduciary judgment when considering how best to maximize stockholder value. "That duty may not be delegated to stockholders." *Time*, 571 A.2d at 1154. Diverse and atomistic stockholders "may have idiosyncratic reasons for preferring

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decisions that misallocate capital." *Trados II*, 73 A.3d at 38. More pertinent to the current case, "a particular class or series of stock may hold contractual rights against the corporation and desire outcomes that maximize the value of those rights." [*Trados II*, 73 A.2d at 38.]

"A board does not owe fiduciary duties to preferred stockholders when considering whether or not to take corporate action that might trigger or circumvent the preferred stockholders' contractual rights." [*Trados II*, 73 A.3d at 39.] ... "Preferred stockholders are owed fiduciary duties only when they do not invoke their special contractual rights and rely on a right shared equally with the common stock." [*Trados II*, 73 A.3d at 39–40.]...

***22** Because the fiduciary principle does not protect special preferences or rights, the fiduciary-based standard of conduct requires that decision makers focus on promoting the value of the undifferentiated equity in the aggregate. Given this obligation, "it is the duty of directors to pursue the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred." *LC Capital*, 990 A.2d at 452. ...

Consequently, it generally "will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, *etc.*, of preferred stock." *Equity–Linked Invs., L.P. v. Adams*, 705 A.2d 1040, 1042 (Del. Ch. 1997) (Allen, C.). "[I]n circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is possible that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders." [*Trados I*, 2009 WL 2225958, at *7.] "This principle is not unique to preferred stock; it applies equally to other holders of contract rights against the corporation." [*Trados II*, 73 A.3d at 42.]

...

3. The Standard of Review

To determine whether directors have complied with the fiduciary standard of conduct, Delaware courts evaluate their actions through the lens of a standard of review. "Delaware has three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny, and entire fairness."[39] The allegations of the Complaint support a reasonable inference that the directors acted to benefit Oak Hill, making entire fairness the applicable standard of review. The allegations of the Complaint also support a reasonable inference that the decision to generate funds to pay off Oak Hill by pursuing a course amounting to a *de facto* liquidation was not entirely fair to the undifferentiated equity. The claim for breach of fiduciary duty therefore survives analysis under Rule 12(b)(6).

[39] *Reis v. Hazelett Strip–Casting Corp.*, 28 A.3d 442, 457 (Del. Ch. 2011). Delaware's intermediate standard of review—enhanced scrutiny—is not implicated by this case.

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Delaware's default standard of review is the business judgment rule. The rule presumes that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson*, 473 A.2d at 812. Unless a plaintiff rebuts one of the elements of the rule, "the court merely looks to see whether the business decision made was rational in the sense of being one logical approach to advancing the corporation's objectives." *Dollar Thrifty*, 14 A.3d at 598. Only when a decision lacks any rationally conceivable basis will a court infer bad faith and a breach of duty. The business judgment rule thus provides "something as close to non-review as our law contemplates." *Kallick v. Sandridge Energy, Inc.*, 68 A.3d 242, 257 (Del. Ch. 2013) (Strine, V.C.). This standard of review "reflects and promotes the role of the board of directors as the proper body to manage the business and affairs of the corporation." *Trados I*, 2009 WL 2225958, at *6. *See generally* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 Vand. L. Rev. 83 (2004).

***26** Delaware's most onerous standard of review is the entire fairness test. When entire fairness governs, the defendants must establish "to the *court's* satisfaction that the transaction was the product of both fair dealing *and* fair price." *Cinerama, Inc. v. Technicolor, Inc.*, (*Technicolor Plenary*), 663 A.2d 1156, 1163 (Del. 1995) (internal quotations omitted). "Not even an honest belief that the transaction was entirely fair will be sufficient to establish entire fairness. Rather, the transaction itself must be objectively fair, independent of the board's beliefs." *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1145 (Del. Ch. 2006).

At the pleading stage, to change the standard of review from the business judgment rule to entire fairness, the complaint must allege facts supporting a reasonable inference that there were not enough sufficiently informed, disinterested individuals who acted in good faith when taking the challenged actions to comprise a board majority. *See Aronson*, 473 A.2d at 812 (noting that if "the transaction is not approved by a majority consisting of the disinterested directors, then the business judgment rule has no application"). If a board is evenly divided between compromised and non-compromised directors, then the plaintiff has succeeded in rebutting the business judgment rule. Consequently, to determine whether to intensify the standard of review from business judgment to entire fairness, a court counts heads. If a director-by-director analysis leaves insufficient directors to make up a board majority, then the court will review the board's decision for entire fairness.

... To plead that a director was interested and therefore cannot count towards the requisite majority, a plaintiff can allege facts showing that the director received a personal financial benefit from a transaction that is not equally shared by the stockholders. Or a plaintiff can allege facts showing that the director was a dual fiduciary and owed a competing duty of loyalty to an entity that itself stood on the other side of the transaction or received a unique benefit not shared

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with the stockholders. To plead that a director was not independent and therefore cannot count towards the requisite board majority, a plaintiff can plead facts showing a director is sufficiently loyal to, beholden to, or otherwise influenced by an interested party to undermine the director's ability to judge the matter on its merits.

***27** A plaintiff also may seek to call into question a director's ability to count as part of the requisite majority by alleging facts that call into question whether the director acted in good faith. Delaware law "clearly permits a judicial assessment of director good faith" for the purpose of rebutting the business judgment rule. *Disney II*, 906 A.2d at 53 ... "A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation." [*Disney II*, 906 A.2d at 67.] "It makes no difference the reason why the director intentionally fails to pursue the best interests of the corporation." [*Disney I*, 907 A.2d at 754.] Bad faith can be the result of "any emotion [that] may cause a director to [intentionally] place his own interests, preferences or appetites before the welfare of the corporation," including greed, "hatred, lust, envy, revenge, ... shame or pride." [*RJR Nabisco*, 1989 WL 7036, at *15.]

In this case, a total of nine directors served on the Board during the time period covered by the Complaint: Morse, Pade, Scott, Domeyer, Kupietzky, Morgan, Ng, Jarus, and Pourzanjani. During this period, the number of directors fluctuated between five and eight. For entire fairness to apply, the Complaint must call into question the interests of either three or four directors, depending on the composition of the Board. The Complaint's allegations adequately call into question the interests of seven directors. ...

a. The Oak Hill Directors

Morse and Pade were principals of Oak Hill, and Scott was a vice president at Oak Hill. In those capacities, they owed fiduciary duties to Oak Hill. The Complaint's core theory is that Oak Hill wanted the Company to engage in a *de facto* liquidation to raise cash that Oak Hill could extract preferentially through its Redemption Right. For purposes of evaluating that theory, Morse, Pade, and Scott cannot count as independent or disinterested directors because each faced the dual fiduciary problem that the Delaware Supreme Court identified in *Weinberger*.

***28** In the landmark *Weinberger* decision, the Delaware Supreme Court held that there is "no dilution" of the duty of loyalty when a director "holds dual or multiple" fiduciary obligations. 457 A.2d at 710. "If the interests of the beneficiaries to whom the dual fiduciary owes duties are aligned, then there is no conflict." *Trados II*, 73 A.3d at 46–47; *see Van de Walle v. Unimation, Inc.*, 1991 WL 29303, at *11 (Del. Ch. Mar. 7, 1991). But if the interests of the beneficiaries diverge, the fiduciary faces an inherent conflict of interest. "There is no 'safe harbor' for such divided loyalties in Delaware." *Weinberger*, 457 A.2d at 710.

The Complaint's allegations support a reasonable inference that at some point in 2011, Oak

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Hill's interests as a venture capitalist holding the Preferred Stock diverged from the interests of the Company and its common stockholders. Venture capitalists tend to seek high returns over a short period of time, typically a "ten-fold return of capital over a five-year period." Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital–Financed Firms*, 2002 Wis. L. Rev. 45, 60. To achieve these returns, venture capitalist try to focus resources on their likely winners while cutting their losses on likely losers. In particular,

> VC firms strive to avoid a so-called "sideways situation," also known as a "zombie company" or "the living dead," in which the entity is profitable and requires ongoing VC monitoring, but where the growth opportunities and prospects for exit are not high enough to generate an attractive internal rate of return. These companies are routinely liquidated, usually via trade sales, by venture capitalists hoping to turn to more promising ventures.

Trados II, 73 A.3d at 51 (internal citations and quotations omitted). These preferences interact with the return profile of preferred stock, which "carries special rights that create specific economic incentives that differ from those of common stock." *Id.* at 48. ... The distorting effects of the preferred stock's special rights "are most likely to arise when, as is often the case, the firm is neither a complete failure nor a stunning success." *Trados II*, 73 A.3d at 49. The business model of VC firms and the return profile of preferred stock thus combine to generate interests that can diverge substantially from the interests of the undifferentiated equity in the aggregate. *Id.* at 50–51.

The Complaint supports a reasonable inference that by 2011, Oak Hill feared the Company would become a sideways situation and wanted to get its capital back as soon as possible. The Company's revenue had declined to $141 million, down from over $200 million in the year before Oak Hill invested. Compl. ¶¶ 28, 43. The Company was generating net income and would have had the potential to redeem small blocks of the Preferred Stock over time. *Compare Thoughtworks*, 7 A.3d at 980–81. But while that option was superior for the common stockholders, it was suboptimal for Oak Hill. The Complaint supports a reasonable inference that Oak Hill sought to use the Redemption Right to get back as much of its capital as possible. Oak Hill therefore used its influence as a controlling stockholder to cause the directors to pursue a *de facto* liquidation of the Company. That would generate a pool of otherwise unavailable cash which Oak Hill then could extract through redemption payments.

***29** The Complaint supports a reasonable inference that beginning in 2011, the Oak Hill Directors sought to serve Oak Hill's interests, rather than the interests of the Company. The allegations of the Complaint indicate that the Oak Hill Directors focused on the Redemption Right, and they identify a series of actions that benefited Oak Hill by creating a pool of cash that would maximize the value of the Redemption Right:

- In 2011, the Company stopped making acquisitions or investing in growth and began

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stockpiling cash. By the end of the year, its cash reserves had nearly doubled, from $13.2 million at the end of 2010 to $23.7 million at the end of 2011. The accumulation of cash benefitted Oak Hill by providing funds that could be used for redemptions.

• In June 2011, the Oak Hill Directors participated in a change of management. Kupietzky left, and Domeyer emerged as the new CEO. In December, an outside director (Pourzanjani) resigned. At this stage of the proceedings, the plaintiff is entitled to the reasonable inference that these changes were linked to a new business strategy that sought to maximize the value of the Redemption Right.

• During the second half of 2011, the Company prepared to sell two of its four businesses. In January 2012, the Oak Hill Directors joined the rest of the Board in approving the sale for total proceeds of $15.4 million. This was less than a third of what the Company had paid to buy just two of the companies that comprised part of the divested businesses. The Company's annual revenue dropped from $141 million pre-sale to $89 million post-sale, suggesting a multiple of sales price to revenue of 0.3. The timing and terms support a reasonable inference that the Company sold the lines of business to generate cash for redemptions.

• In May 2012, Pade voted with Ng as the two members of the Compensation Committee to give Domeyer, Murray, and Greene bonuses that would be triggered if the Company redeemed at least $75 million of Preferred Stock. The terms and timing support a reasonable inference that Pade and Ng were seeking to incentivize management to pursue redemptions for Oak Hill's benefit.

• During 2012, the Company continued to stockpile cash. By the end of the year, the Company's cash reserves had doubled a second time, reaching $50 million.

• In August 2012, the Oak Hill Directors joined with the other members of the Board in forming the Committee to evaluate the Company's alternatives for raising capital and to negotiate with Oak Hill over the terms of any redemption. The plaintiff is entitled to the reasonable inference that the Oak Hill Directors had been focused on the Redemption Right and planning for its exercise before this point. That is what sophisticated repeat players do.

• Pade bargained aggressively with the Committee over the Redemption Right, including demanding a 12% cumulative paid-in-kind dividend on any unredeemed shares and offering an illusory forbearance agreement. At the earliest possible date, Oak Hill exercised the Redemption Right for the full amount. These positions reinforce the inference that Oak Hill wanted to get as much capital out via its Redemption Right and to do so as soon as possible.

Given this series of events, it is reasonable to infer that Oak Hill wanted to maximize the value of its contractual Redemption Right and that the Oak Hill Directors pursued Oak Hill's interests.

The Complaint supports a reasonable inference that this pattern continued after the March

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Redemption. In early 2014, the Company negotiated to sell one of its two remaining lines of business. Recognizing that any cash generated by the sale could be used to redeem the Preferred Stock, and correctly perceiving that this could create a conflict for the Oak Hill Directors, the Board charged the Committee with overseeing the negotiations. Once a deal had been reached, the Board charged the Committee with determining how much of the proceeds to use for redemptions and with implementing a broad restructuring initiative that would free up more cash for redemptions. In August 2014, the full Board adopted a business plan that contemplated further staff reductions and the sale of one segment of the Company's lone remaining line of business, Vertical Markets. The Oak Hill Directors participated in each of these decisions. Based on the sharply curtailed business plan, the Board approved the September Redemption.

***30** Four months later, the Company sold Shopwiki for $600,000. In 2010, the Company had acquired Shopwiki for $17 million, and it was the Company's principal remaining source of revenue. The sale capped a remarkable two years during which the Company sold assets that generated 92% of its revenue and used the resulting cash, along with cash generated from operations, to redeem shares of Preferred Stock.

One reasonable explanation for the change in business strategy and large-scale divestitures is that the Company sought to generate cash to facilitate upcoming redemptions that it otherwise would not be able (or required) to make. The Oak Hill Directors were dual fiduciaries who owed duties both to Oak Hill and the Company. The Complaint's allegations support a reasonable inference that the Oak Hill Directors furthered Oak Hill's interests. The three Oak Hill Directors cannot be considered disinterested or independent for purposes of determining the standard of review.

b. Domeyer

Domeyer served on the Board during the period when the Company took steps to maximize the value of the Redemption Right. Domeyer was not independent because she was a highly compensated senior officer in a Company controlled by Oak Hill. "Under the great weight of Delaware precedent, senior corporate officers generally lack independence for purposes of evaluating matters that implicate the interests of the controller." [*In re Ezcorp Consulting Agreement Deriv. Litig.*, 2016 WL 301245 at *35 (Del. Ch. Jan. 25, 2016) (collecting cases).] The fact that officers derive their principal income from their employment "powerfully strengthens the inference" that they cannot act independently from the controlling stockholder. *Mizel v. Connolly*, 1999 WL 550369, at *3 (Del. Ch. July 22, 1999). Domeyer derived her principal income from her employment. Compl. ¶ 17.

Domeyer also was interested in the steps taken to achieve the redemptions. Under Delaware law, a director is considered interested "when he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders." *Rales*, 634 A.2d at 936. "Delaware courts apply a subjective 'actual person' standard to determine whether a 'given' director was

likely to be affected in the same or similar circumstances." *McMullin*, 765 A.2d at 923. "The benefit received by the director and not shared with stockholders must be of a sufficiently material importance, in the context of the director's economic circumstances, as to have made it improbable that the director could perform her fiduciary duties ... without being influenced by her overriding personal interest." *Trados I*, 2009 WL 2225958, at *6 (internal quotation omitted).

Domeyer entered into a bonus agreement with the Company that contemplated a special payment for achieving $75 million in redemptions of the Preferred Stock. None of the common stockholders enjoyed the prospect of a similar payout. Domeyer thus stood to receive a personal financial benefit not equally shared by the stockholders.

The Complaint's allegations support a reasonable inference that the magnitude of the benefit was material to Domeyer—and intentionally so. For achieving the a total of $85 million in redemptions, Domeyer received a bonus of $587,184. This figure is sufficiently large to support an inference of materiality at the pleading stage, particularly when the purpose of the bonus appears to have been to incentivize Domeyer to pursue redemptions that would benefit Oak Hill.

c. The Outside Directors

***31** The Complaint adequately alleges that Ng, Morgan, and Jarus acted disloyally for the bad faith purpose of maximizing the value of Oak Hill's Redemption Right by generating funds for redemptions that otherwise would not have been available, rather than by seeking to maximize the value of the Company for the benefit of its residual claimants. This is not the only possible inference, but it is a reasonable inference at this stage.

Taken as a whole, the allegations of the Complaint identify a constellation of actions, all of which favored the interests of Oak Hill by maximizing the value of its Redemption Right. First, the Company departed starkly from its historic business strategy. Until 2011, the Company emphasized long-term growth through reinvestment and acquisitions. The Company did not accumulate or sit on large stockpiles of cash. This only changed as Oak Hill's redemption right approached. The temporal relationship supports an inference that the directors' business decisions were motivated by the Redemption Right.

Second, the magnitude of the Company's divestitures suggests an intentional effort to create a pool of capital that Oak Hill could tap. Between 2012 and 2014, the Company sold three of its four lines of business and the "crown jewel" of its only remaining line of business. Several of these sales took place at prices far below what the Company had paid to acquire the assets and at times when management believed conditions were unfavorable. A reasonable inference at this stage is that the directors sought to generate cash for upcoming redemptions, even if that course was unfavorable to the Company's long-term prospects and the interests of its undifferentiated equity.

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Third, Ng, Morgan, and Jarus took specific actions that helped Oak Hill. In May 2012, Ng joined Pade in approving bonus arrangements for the three senior officers. The agreements gave the officers a financial incentive to pursue redemptions.

During the second half of 2012, Morgan and Jarus negotiated with Oak Hill over the terms of a redemption. Based on the allegations of the Complaint, however, the positions they took favored Oak Hill and did little if anything for the Company. For example, the Committee proposed that Oak Hill receive a 2% cumulative paid-in-kind dividend on unredeemed shares in exchange for a forbearance right that Oak Hill could terminate on thirty-days' notice, under circumstances where Oak Hill had no effective means of enforcing the Redemption Right if the Company did not have legally available funds, and when it was highly unlikely that the Company could generate additional funds for redemptions during the forbearance period. Although the evidence at a later stage may suggest something different, it appears at the pleadings stage that the Committee offered a material benefit to Oak Hill (the 2% cumulative dividend) for little if anything in return.

Morgan and Jarus reinforced the impression that they were acting for the benefit of Oak Hill after Oak Hill exercised the Redemption Right. Oak Hill demanded a redemption payment of $45 million. Management had opined previously that the Company needed a cash reserve of $10 million, which would not permit a $45 million redemption. Morgan and Jarus asked management to re-assess the reserve. After management conveniently reduced the reserve to $2 million, Morgan and Jarus endorsed making the full $45 million redemption on the terms requested by Oak Hill.

***32** Morgan and Jarus again favored Oak Hill after the sale of the Domain Monetization business in May 2014. They took charge of both determining the terms for a further redemption and implementing a restructuring initiative that would make additional funds available for redemptions. Morgan and Jarus twice rejected management's business plans, insisting each time that management make deeper cuts that would free up more funds for Oak Hill. Morgan and Jarus then voted as part of the Board to approve a business plan that contemplated deeper staff cuts and the sale of one segment of the Company's lone remaining line of business. Based on the business plan, Morgan and Jarus recommended a redemption payment of $40 million to Oak Hill.

By taking these actions, Morgan and Jarus effectively treated Oak Hill as a creditor with an enforceable lien on the corporation's assets. "But the holder of preferred stock is not a creditor of the corporation. Such a holder has no legal right to annual payment of interest, as long term creditors will have, and most importantly has no maturity date with its prospect of capital repayment or remedies for default." *HB Korenvaes*, 1993 WL 205040, at *5; *accord Harbinger*, 906 A.2d at 225 ("The holder of preferred stock is not a creditor of the corporation, and therefore does not have access to the remedies available to a creditor in addition to those generally available as a stockholder."). "A redemption right does not give the holder the

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absolute, unfettered ability to force the corporation to redeem shares under any such circumstances." *Carsanaro*, 65 A.3d at 644. "Mandatory redemption rights provide limited protection and function imperfectly, particularly when a corporation is struggling financially." *Thoughtworks*, 7 A.3d at 992. The Redemption Provisions did not require that the Company effectively liquidate itself. That Morgan and Jarus repeatedly took steps to benefit Oak Hill as if it were a secured creditor supports a reasonable inference that they acted to maximize the value of Oak Hill's Redemption Right rather than the long-term value of the Company for the benefit of the undifferentiated equity.

Although this course of conduct by itself is sufficient to call into question the motives of the outside directors, it is critical to remember that they acted in the shadow of a controlling stockholder, and that Morgan and Ng had additional reasons to favor Oak Hill's interests. A controlling stockholder transaction "of course is the context in which the greatest risk of undetectable bias may be present." *Kahn v. Tremont Corp.*, 1996 WL 145452, at *7 (Del. Ch. Mar. 21, 1996) (Allen, C.), *rev'd on other grounds*, 694 A.2d 422 (Del. 1997). Although in theory a special committee of independent directors "is best positioned to extract a price at the highest possible level because it does not suffer from the collective action problem of disaggregated stockholders," the men and women who populate the committees are rarely individuals "whose own financial futures depend importantly on getting the best price and, history shows, [they] are sometimes timid, inept, or ..., well, let's just say worse." *In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 619 (Del. Ch. 2005) (Strine, V.C.). Particularly when a controller is present, there is the risk that "that the outside directors might be more independent in appearance than in substance." *Id.*; *accord* Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 Del. J. Corp. L. 673, 678 (2005) (explaining that when a controller is present, there is "an obvious fear that even putatively independent directors may owe or feel a more-than-wholesome allegiance to the interests of the controller, rather than to the corporation and its [minority] stockholders").

***33** Within this context, Morgan and Ng's links to Oak Hill take on greater color. Morgan worked for fifteen years as a corporate attorney with the law firm that acts as Oak Hill's long-time outside counsel, he served with Pade on another Board, and his son and Pade's son were friends. In 2011, Ng received $24 million when Oak Hill purchased a block of his otherwise illiquid stock. This decision need not consider whether these facts would be sufficient standing alone to call into question either director's motives. Considered together with the other allegations of the Complaint, these facts support the inference that the outside directors cannot be considered disinterested or independent for purposes of determining the standard of review.

...

5. Applying The Entire Fairness Standard At The Pleading Stage

When entire fairness applies, the defendant fiduciaries have the burden "to demonstrate that the

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challenged act or transaction was entirely fair to the corporation and its shareholders." *Disney II*, 906 A.2d at 52. Fair dealing "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained." *Weinberger*, 457 A.2d at 711. Fair price "relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." *Id.* Although the two aspects may be examined separately, "the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness." Id. But "perfection is not possible, or expected ...." *Id.* at 709 n.7. In this case, the Complaint supports a reasonable inference that the defendants' actions were not fair to the undifferentiated equity.

***35** In terms of fair price, the Company radically altered its business strategy in the shadow of Oak Hill's Redemption Right. The Company reversed a long-time business plan that focused on achieving growth for the long term both internally and through acquisitions, and it began instead to stockpile cash. Beginning in 2012, the Company divested its major assets at prices substantially below what it had paid to acquire them. In January 2012, the Company sold two of its four business lines for $15.4 million, having paid $46.5 million to acquire only some of the assets in 2007. Those businesses contributed nearly half of the Company's revenue. In December 2014, the Company similarly sold Shopwiki, the crown jewel of its then-lone remaining line of business, for only $600,000. The Company had acquired the business in 2010 for $17 million.

The defendants might ultimately prove that these prices were fair. But at the pleading stage, the Complaint's allegations give rise to a reasonable inference that the Company failed to obtain fair prices in these transactions. Equally importantly, the Complaint supports a reasonable inference that it was not fair to the undifferentiated equity to stockpile the cash from the Company's operations and these transactions so that it would be available for redemptions. Before the Redemption Right ripened, the Company did not reinvest its accumulated cash. It held the cash until March 2013, when it used $45 million to redeem shares of Preferred Stock. The Complaint supports a reasonable inference that fiduciaries acting loyally would have continued to manage the Company for the long term, rather than stockpiling cash so that Oak Hill could sweep it up. The Complaint supports a reasonable inference that the directors unnecessarily diverted value to Oak Hill that otherwise would have accrued to the undifferentiated equity.

Although the Preferred Stock had a $150 million liquidation preference and carried a right to mandatory redemption at that price, Oak Hill did not have the ability to force the Company to make redemptions beyond the funds that were legally available. Oak Hill's Preferred Stock also did not carry a cumulative dividend. Preferred stock often carries a cumulative dividend which steadily increases the liquidation preference. *See Trados II*, 73 A.3d at 48. When present, a cumulative dividend reduces the prospect that a corporation will generate value for the

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undifferentiated equity, because the company not only must continue as a going concern but also generate "a sufficient return to escape the gravitational pull of the large liquidation preference and cumulative dividend." *Id.* at 77. In such a situation, the common stock may be functionally worthless, because the company can never realistically generate a sufficient return to pay off the preferred stockholders and yield value for the common. *Id.*

The Preferred Stock in this case did not pay a cumulative dividend. Dkt. 36, Ex. B at 4. Once the Redemption Right ripened, the Company had an obligation to use its legally available funds to redeem shares over time up to a total amount of $150 million, but the amount of the redemption obligation would not increase. To the contrary, because the Company would be redeeming the preferred over time with future dollars, the present value of the obligation would diminish. Over a long-term time horizon, the Company conceivably could have grown its business, gradually redeemed all of the Preferred Stock, and then generated returns for its common stockholders. The Preferred Stock was effectively trapped capital, and the Company could have used that capital for the benefit of the residual claimants. That type of scenario obviously was not appealing to Oak Hill, which understandably wanted as much of its capital back, as soon as possible, so it could redeploy its capital in higher-returning investments. But what was beneficial to Oak Hill and what was fair to the Company and its common stockholders are two different things. The latter is measured by what faithful fiduciaries could have achieved in light of Oak Hill's relatively weak contractual position.

***36** Instead of using the leverage that the Company had over Oak Hill for the benefit of the Company and its residual claimants, the directors engaged in hasty divestitures at seemingly fire-sale prices that virtually wiped out the Company's ability to generate income. Before the divestitures, the Company's four business lines generated $144 million in revenue. After the divestitures, the Company had one remaining line of business that generated $11 million in annual revenue and a net loss of $500,000. The allegations of the Complaint support a reasonable inference that dismembering the Company to maximize the value the Redemption Right did not yield a fair price for the undifferentiated equity.

The Complaint's allegations similarly support a reasonable inference that the defendants' conduct fell short in terms of fair dealing. When directors act in bad faith, it is "extraordinarily difficult for the defendant directors to prove that the transaction was entirely fair to the corporation because it would be difficult to demonstrate fair process." *Disney I*, 907 A.2d at 749 n.422. As explained above, it is reasonably conceivable that the directors acted in bad faith by effectively liquidating the company to maximize the value of Oak Hill's Preferred Stock.

The Complaint also alleges specific facts suggesting that particular aspects of the process were unfair. The Board used bonuses to incentivize management to favor a sale, which effectively converted them "from holders of equity interests aligned with the common stock to claimants whose return profile and incentives closely resembled those of the preferred." *Trados II*, 73 A.3d at 61. The Complaint also alleges that the Company sold assets during periods that

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management considered unfavorable, which conceivably contributed to those assets being sold for seemingly low prices.

It bears emphasizing that this is a pleading-stage decision. It is possible that the directors approved the challenged course of action because they believed in good faith that it was in the best interest of the undifferentiated equity. Even though Oak Hill lacked a cumulative dividend, it is possible that they concluded that the Company’s value would never exceed Oak Hill’s $150 million liquidation preference, perhaps because the Company had no meaningful prospect as a going concern. Under those circumstances, the outside directors might reasonably conclude that gradually liquidating the business was value-maximizing, since it delivered value to the fulcrum security in the capital structure while taking nothing away from the worthless common stock. At the motion to dismiss stage, however, the plaintiff receives the benefit of all reasonable inferences. For the reasons explained at length above, it can be reasonably inferred that the directors acted to maximize the value of Oak Hill’s Preferred Stock rather than seeking to promote the long-term value of the Company for the benefit of the undifferentiated equity, and that the resulting transactions were unfair to the Company’s common stockholders.

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