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# The Nine Systems Corp. Shareholder Litigation: A Primer in Improper Corporate Governance

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## The Nine Systems Corp. Shareholder Litigation: A Primer in Improper Corporate Governance

The long saga of what ultimately became known as the “Nine Systems Corp.” shareholder litigation has wound its way through the Delaware Chancery Court, where it began in 2008, to a conclusion in the Delaware Supreme Court on December 11, 2015. The path from corporate recapitalization in 2002 to the final order of the Delaware Supreme Court holding that the plaintiff shareholders of the entity originally known as “Streaming Media Corp.” were not entitled to any monetary damages notwithstanding what the court described as a “grossly unfair process” provides a wealth of guidance for attorneys advising early stage enterprises as to how to properly address corporate governance and shareholder communication issues.



The plaintiffs included individuals and entities that invested several million dollars in Nine Systems Corp. (NSC) during 1999-2002 and were holders of Common and/or Series A Preferred Shares until NSC was acquired by Akamai Technologies, Inc. in 2006. The plaintiffs’ aggregate ownership interest in NSC following their investment was approximately 20-25 percent of NSC’s equity value. The defendants included four of NSC’s five directors during the relevant time and four entities that in the aggregate controlled no less than 56 percent of NSC’s aggregate equity value and were referred to by the court as “NSC’s Control Group.”

In late 2001 and early 2002, members of NSC’s Control Group loaned approximately \$7.5 million to NSC. Very shortly thereafter, the NSC Board approved a “recapitalization” of NSC whereby all of NSC’s senior debt would be converted into Series A Preferred Stock, new investors would receive Series B Preferred Stock and the newly invested capital would be used to fund strategic acquisitions. Through a series of reverse stock splits and charter amendments, approved by written consent of NSC’s Control Group, the “recapitalization” was implemented and NSC’s Control Group, through conversion of the outstanding debt and the investment of an additional \$2.5 million in capital increased its ownership of NSC’s equity value from 56 percent to 90 percent.

Later in 2002 NSC circulated a notice to all of its shareholders, which advised that in August 2002, “in order to simplify and strengthen its capital structure, debt holders converted debt to equity and [the Company] declared a one for twenty reverse stock split.” This notice, however, did not disclose who ultimately benefited from the recapitalization or what benefits they received.

The NSC minority shareholders received no further communications of any kind from NSC until November 2006 when NSC sent proxy materials to its shareholders seeking approval of the proposed acquisition of NSC by Akamai Technology, Inc. for \$175 million. The plaintiffs’ complaint, filed in August 2008, alleged that the proxy materials included the first information received by the plaintiffs that the minority shareholders of NSC held less than 6 percent of NSC’s fully diluted securities and that the NSC Control Group held approximately 90 percent of NSC’s equity securities. The Akamai transaction closed in December 2006 for \$175 million.

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The plaintiffs' complaint put forth four counts: (1) directors' breaches of fiduciary duties; (2) breaches of fiduciary duties owed by controlling shareholders to minority shareholders; (3) aiding and abetting by the controlling shareholders of the investors appointing directors in the breach of their fiduciary duties; and (4) unjust enrichment by the directors and controlling shareholders. The plaintiffs sought: (a) rescission of the recapitalization or rescissory damages; (b) recovery for damages sustained as a result of the defendants' breaches of fiduciary duties; (c) disgorgement of the full profits received by the defendants as a result of the sale of NSC to Akamai Technology; and (d) attorneys' fees.

As would be expected, there were a number of procedural motions to dismiss or narrow some or all of the plaintiffs' claims. This article, however, will focus on the actions taken, or not taken, by the defendant directors and shareholders in the context of corporate governance and shareholder communication, and how those actions or omissions to act impacted the judicial analysis of the plaintiffs' claims.

The Chancery Court summarized the impact of the recapitalization as follows: "through the recapitalization, NSC's Control Group went from holding 56 percent of NSC's equity to 90 percent. The implication is that the rest of NSC's shareholders went from holding 44 percent of NSC's equity to 10 percent...the alleged primary effect of the recapitalization was 'an extraction from [NSC's] public shareholders, and a redistribution to [NSC's Control Group], of a [substantial] portion of the economic value and voting power embodied in the minority interest.'" It is important to note that the recapitalization was approved by the written consent of NSC's Control Group, which constituted a majority of NSC's outstanding voting securities and that at the time of the recapitalization *all shareholders* executed a stockholders agreement, which included a reference to a reverse stock split and an exchange of debt for preferred stock. However, neither the stockholders agreement nor the 2002 notice to stockholders disclosed who benefited from the recapitalization or what benefits they received.

The Chancery Court looked closely at the process, or, in some instances, the lack of process, followed by the NSC Board of Directors in formulating, approving and implementing the recapitalization. For example, the court found that the board did not obtain any independent valuation of NSC in connection with the recapitalization. Instead, the individual primarily responsible for determining the value of the

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company, as well as the conversion rates for the convertible preferred stock issued in connection with the recapitalization, was a director of, and the holder of slightly less than one half of the equity of one member of, NSC's Control Group and that his calculations were literally a group of "handwritten guesstimates scratched out on a single piece of paper." Internal memoranda were circulated and "informal meetings" were held amongst selected board members and board meetings were scheduled in order to conflict with the religious practices of one board member who had strongly stated his opposition to the terms of the recapitalization. The board, by a vote of four to one, approved the recapitalization in early 2002, but some of the terms changed by the time the convertible preferred stock was issued later in 2002. Necessary changes to NSC's charter documentation were also made. However, notwithstanding a general notice to shareholders in 2002 regarding the recapitalization, specific information as to who was receiving the convertible preferred stock and on what terms were not disclosed to the company's other stockholders who were not involved in the approval of these actions.

During the four year period following the recapitalization in 2002, NSC had little if any communication with most of its stockholders (notwithstanding that during this time period NSC moved its headquarters from New Jersey to California and changed its name). There were no annual meetings or director elections, although there was an informational meeting in February 2006, which had "less than a handful" of attendees. In late 2006, Akamai acquired NSC in a \$175 million merger in which each shareholder of NSC received consideration worth approximately \$13.00 per share. The Chancery Court made clear that while almost all investors in NSC received a positive return on their initial investment because of the merger with Akamai, some recognized a greater return than others (the court noted that those who had invested in Preferred B-1 stock received almost a 2,000 percent return). When the minority shareholders, through the information included in the proxy materials circulated in advance of the Akamai merger, became aware of the potential conflicts of interest in the recapitalization, they filed suit and challenged the recapitalization's fairness.

In evaluating the counts included in the plaintiffs' pleadings, the Chancery Court focused on, among other fundamental issues, the application of fiduciary responsibility at both the board and at the "controlling stockholder" levels, stating that "[b]ecause a controlling stockholder has the power, by definition, to act selfishly to the detriment of the corporation's minority stockholders, it is said to owe a fiduciary duties to those stockholders in certain situations, including when it 'stands on both sides of [a] transaction with the corporation.'" In this regard, the Chancery Court found that stockholder members of the NSC Control Group constituted a "controlling stockholder for these purposes and therefore owned fiduciary duties to NCS's other stockholders." Further, the court observed that at the board level, while it is not automatically improper for a director of a Delaware corporation to also be a fiduciary for another beneficial party, such as a venture capital firm, "a director must put the interests of the stockholders above self-interest and, by extension, the interests of the other beneficiaries to whom the director may also owe fiduciary duties. Put simply, [t]here is no safe harbor for such divided loyalties in Delaware." Applying these standards to the corporate governance process by which the recapitalization was approved and implemented, the court concluded that because the NSC Control Group, as both stockholders and directors of the company, stood on "both sides of the transaction" and "received a benefit not shared with the company's other stockholders" the "entire fairness" doctrine would apply and the NSC Control Group would bear the burden of demonstrating the "entire fairness of the recapitalization."

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Having established the standard to be applied in reviewing the transaction, the court then turned to the two prongs of the “entire fairness” doctrine: fair dealing and fair price, which the court alternatively described as “procedural fairness and substantive fairness.” When a transaction is subject to the entire fairness doctrine, the burden falls to the parties who approved the transaction to establish the entire fairness of the transaction in issue. As to fair dealing, or procedural fairness, the analysis focuses on “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.” Here, the court determined that the initiation of the recapitalization was fair, as the company was running out of money, its business plan was generally unsuccessful and management had reasonably determined that the company needed to grow quickly or be at risk of liquidation. However, the court further determined that the actions undertaken to implement the recapitalization were not fair.

In reaching this determination, the court cited that at least one director was consistently and knowingly excluded from board meetings and “informal calls” in which the structure of the recapitalization was developed. Further, the court observed that directors “who owed fiduciary duties to the entities which would benefit from the recapitalization controlled the process” thereby tainting their ability to fulfill their fiduciary duties to all stockholders, not just a particular subset of stockholders.

As to the board’s valuation process, the court observed that no director had any material input into the valuation, no independent valuation was solicited and the directors apparently relied solely upon the highly informal calculations of a principal of one of the company’s larger stockholders, notwithstanding that individual’s obvious conflict of interest. To be clear, there is no requirement under Delaware law to retain an independent financial adviser in such circumstances. However, the court found that the directors were not adequately informed about the basis and substance of the valuation that served as the basis for the directors’ actions.



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Other indicia of an unfair process cited by the court included the fact that only one existing stockholder received an option to invest in the recapitalization and that this right to invest was not disclosed to the full board nor to the company's other stockholders. The court found that the granting of this option was key to such stockholder's vote in favor of the recapitalization, ensuring an affirmative majority. The court also criticized the manner in which the board communicated with those stockholders of the company who were not part of the NSC Control Group. Notices as to actions taken in connection with the recapitalization, including approval of charter amendments were not timely and/or materially misleading, particularly as to the absence of sufficient information as to the dilutive impact of the recapitalization. Citing a string of precedential Delaware decisions, the court stated that "once the directors traveled down the road of partial disclosure...they had an obligation to provide the stockholders with an accurate, full and fair characterization of those historic events" and that "the failure to disclose this material information is powerful evidence of unfair dealing."

In considering whether the board had satisfied the requirement of fair price or substantive fairness, the court stated that the burden falls to the directors to establish that the valuation of the company for purposes of the recapitalization was "within the proverbial range of fairness: one that a reasonable seller, under all of the circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept." The court commented that "the most persuasive expert valuations tend to be those derived from contemporaneous management valuations—typically, revenue or cash flow projections—because management usually has the strongest incentives to predict the company's financial future accurately and reliably." The court thoroughly reviewed the facts, circumstances and methodologies relied upon by both sides in determining the sufficiency and reliability of their competing calculations of the value of the company at the time of the recapitalization (including whether, for purposes of the litigation, the value should be based on the value of the company at the time of the recapitalization or after giving effect to post-recapitalization acquisitions by the company in advance of the sale to Akamai). Ultimately, the court decided that it was reluctant to conclude that the recapitalization was an "entirely fair transaction," even if it may have been conducted at a fair price, "because of the grossly inadequate process employed by the defendants." The court highlighted the unfairness of the board's valuation process, including the lack of reliable projections, a lack of understanding of the valuation methodology upon which the board based its actions and the board's decision not to seek input from an independent director or independent adviser. As a consequence, although the court commented that although fair price may be the dominant factor in determining whether a transaction may be fraudulent, it held that in this matter the defendants had breached their fiduciary duties inasmuch as "it most hold true that a grossly unfair process can render an otherwise fair price, even when a company's common stock has no value, not entirely fair."

Having completed its analysis of the facts and circumstances of the case in the context of the "entire fairness" doctrine and concluded that the process by which the board of directors had pursued the recapitalization did not satisfy the requirements of "fair dealing," the court held that the NSC Control Group had breached its fiduciary obligations to the other shareholders of the company. However, the court also held that inasmuch as the court concluded that the recapitalization was effected at a "fair price" in which the plaintiffs' stock had no value, the plaintiffs were not entitled to "disgorgement, recessionary or other monetary damages."

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Early stage companies, almost by definition, are subject to inherent risks of conflict of interest. Investors serve as directors; management members are also frequently shareholders. Notwithstanding the finding in this matter that no damages were payable to the plaintiffs, the court's obvious displeasure with how this conflicted board of directors went about its business in structuring and implementing a series of extraordinary corporate events without fulfilling what would appear to be the most basic elements of a "fair process," including the board's failure to adequately understand the duties owed to the company's shareholders, failure to demand adequate information about the underlying valuation, failure to disclose certain terms to the minority shareholders and approval of modifications to the transaction terms that favored insiders, is highly instructional as an example of "what not to do" when seeking to recapitalize or undertake similar transactions involving a closely held corporation. It is critical for boards, and their advisers, to acknowledge the existence of these inherent conflicts of interest and to react accordingly, by educating itself on its fiduciary obligations in such circumstances and utilizing independent directors and/or independent advisers to guide the board through its structuring of such a transaction. Clear, timely and full communication to shareholders is key. A partial nondisclosure is just as problematic as an incorrect or no disclosure. In this particular situation, the board's behavior was wholly inadequate; the fact that no damages were awarded cannot be interpreted in any way as a vindication of its behavior.

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