Chancery Court Provides Guidance on Structuring Financings

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In *Zimmerman v. Crothall,* C.A. No. 6001-VCP (Del. Ch. March 5, 2012), the Delaware Court of Chancery, ruling on a motion for summary judgment, found that the defendants - directors and venture capital investors of Adhezion Biomedical - failed to establish that Adhezion's issuance of preferred equity and convertible debt to the defendants that was not offered to all holders on the same terms were not self-interested transactions. In so doing, however, the court indicated that equity or debt offerings made to all holders on the same terms may be subject to business judgment review, even if otherwise interested directors and/or controlling holders participate in the offering.

Adhezion is a private company engaged in the development and manufacture of medical products. As with many early-stage companies, Adhezion raised most of its financing from venture capital investors. In early 2008, Adhezion issued 375,000 Series A Preferred Units to Originate Ventures for $3 million and, later that year, issued 281,917 Series A Preferred Units to Liberty Ventures II for approximately $2 million, according to the opinion. In connection with these investments, Originate and Liberty secured the right to appoint one director to Adhezion's board. The remaining directors consisted of the chief executive officer and two independent directors.

Between July 2009 and January 2011, Adhezion issued convertible debt and equity, including new preferred equity on a parity with the Series A Preferred Units, to Originate, Liberty, one of the fund-designated directors and the CEO, according to the opinion. During this period, Adhezion was in urgent need of cash to fund its operations and had been unable to secure a deal from outside investors. The plaintiff, a holder of common units, asserted various claims challenging the financing transactions, including breach of fiduciary duty and bad faith, according to the opinion. The defendants moved for summary judgment on all counts.

The court noted that, in deciding whether to grant summary judgment, it was required to determine what standard of review to apply to the challenged transactions. (Although Adhezion is a limited liability company, the operating agreement contained a fiduciary duty standard similar to the one applicable to Delaware corporations generally.) In this context, the court noted, to avoid business judgment review, the plaintiff would have to establish a genuine issue of material fact as to whether a majority of the directors were independent, disinterested, informed or acting in good faith.

In considering the standard of review, the court focused on the allegations of breach of the duty of loyalty. The plaintiff claimed that a majority of the directors, as well as the venture capital investors (which, the plaintiff claimed, were acting as a control group), stood on both sides of the financing transactions and received an exclusive benefit at the expense of the holders of the common units, according to the opinion.

The court first addressed whether the venture capital investors constituted a control group. The court noted that a holder will be deemed "controlling" if it owns a majority interest in the company or exercises "actual control" over the board of directors in the context of a particular transaction. In the latter case, "actual control" is found where a holder or group wields such "formidable" voting or managerial power that it is essentially equivalent to majority voting control. Neither Originate nor Liberty individually held majority control, but they collectively held 66 percent of the voting power and controlled two of the five board seats, according to the opinion. Moreover, as investors in the same security, their economic interests were aligned. While parallel interests alone are not sufficient to support an inference that a control group exists, in this case the plaintiff was able to adduce additional facts, such as correspondence evidencing influence over the financings, supporting a reasonable, albeit not conclusive, inference that a control group existed.

In addressing whether a majority of the board was interested, the court found that the two directors affiliated with the venture capital funds were not independent because of their positions with their respective funds. Additionally, one of the fund-designated directors participated in his individual capacity, which rendered him personally interested. Although the other fund-designated director did not participate in his individual capacity, he was a managing partner of a fund that did, and therefore the plaintiff could ultimately succeed in proving that such director was interested. The court also found that the CEO, who participated in the transactions, had a personal interest.

Finding that three of the five directors, for purposes of the motion, were interested and lacked independence, the court turned to whether the transactions conferred an exclusive benefit on these fiduciaries. In addressing this question, the court looked to the particular features of each of the financing transactions. With regard to the 2009 financing, the court found that it was not open to all members. The plaintiff claimed that the 2009 financing resulted in the issuance of preferred units at an improperly low price. This conferred an exclusive benefit on the defendants - the opportunity, not available to all holders, to buy interests at a discount.

The court likewise found that the February 2010 and January 2011 transactions conferred an exclusive benefit on the defendants. Central to the court's finding was that the transactions were not offered on equal terms to all holders. The court noted that these transactions were structured as two-step offerings, in which, as part of the first step, the existing holders of preferred units were given the opportunity to purchase all of the securities initially offered. In the second step, holders of common units could participate, on a pro rata basis, in the balance of the offering, according to the opinion. "Significantly," the court stated, "the Class A Common Members were permitted to participate on a pro rata basis only in the remaining authorized shares; they were not given the opportunity to maintain their pro rata interest in Adhezion overall." Thus, "the common members bore a risk in each offering that they could be shut out if the first step of the transactions were subscribed fully." If the holders of preferred units purchased more units than their collective pro rata interests, the transactions would be dilutive to the holders of common units. According to the court, this resulted in an exclusive benefit to the defendants to the detriment of the holders generally and, in turn, triggered entire fairness review.

Although the question was not squarely before the court, the opinion suggests that a financing transaction in which all holders are entitled to participate on equal terms up to their pro rata amounts may be entitled to business judgment review, even if the directors or controllers are participating in the financing. In that case, the directors or controllers would not be receiving an exclusive benefit to the detriment of the holders generally - any detriment occasioned upon the remaining holders would be brought on by their own decision not to participate.

In this regard, the *Zimmerman* opinion echoes the opinion in *WatchMark v. ARGO Global Capital,* 2004 WL 2694894, at *4 (Del. Ch. Nov. 4, 2004), where the court applied business judgment review to a preferred stockholder's challenge to a pay-to-play transaction. The *WatchMark* court stated: "Again, all preferred stockholders have an equal opportunity to participate. ... Any disparate treatment between the preferred stockholders is therefore a self-imposed consequence and not the result of any self-dealing." While each financing transaction must be evaluated on its own specific facts and circumstances, and other factors may be relevant to the court's decision whether to apply business judgment review to any particular transaction, companies and their advisers should be aware that making an offering available to all holders could result in a more favorable standard of review.

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