EFiled: Aug 28 2015 04:29PM EDT
Filing ID 57784509
Case Number 281,2015

IN THE SUPREME COURT OF THE STATE OF DELAWARE

MORRIS FUCHS, *et al.*,	§	
	§	No. 281, 2015
Plaintiffs Below,	§	
Appellants, Cross-Appellees,	§	
	§	
v.	§	On Appeal from the
	§	Court of Chancery
WREN HOLDINGS, LLC, *et al.*,	§	of the State of Delaware,
	§	Consolidated C.A. No. 3940
Defendants Below,	§	
Appellees, Cross-Appellants.	§	

APPELLEES' ANSWERING BRIEF ON APPEAL
AND OPENING BRIEF ON CROSS-APPEAL

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Dated: August 28, 2015

TABLE OF CONTENTS

TABLE OF AUTHORITIES v

NATURE OF THE PROCEEDINGS 1

SUMMARY OF ARGUMENT 5

FACTS 7

A. The Genesis and Approval of the Recapitalization 7

B. Events Prior to Closing the Recapitalization 10

C. Closing the Recapitalization 12

D. Post-Recapitalization Events 13

E. The Opinion 15

1. Conclusions on Standing 15

2. Conclusions on Entire Fairness 17

a. Fair Dealing 17

b. Fair Price 17

c. Unitary Fairness 20

d. Damages 21

3. Conclusions as to Other Claims 22

F. The Fee Opinion 22

ARGUMENTS ON APPEAL 24

I. THE TRIAL COURT DID NOT ABUSE ITS DISCRETION BY NOT AWARDING DISGORGEMENT OR RESCISSIONARY DAMAGES 24

A. Question Presented 24

B. Standard and Scope of Review 24

C. Merits of Argument....24

1. Whether to Award Disgorgement or Rescissionary Damages Is Left to the Discretion of the Trial Court. 24

2. The Trial Court Did Not Abuse Its Discretion by Not Awarding Disgorgement or Rescissionary Damages. 26

3. The Trial Court Did Not Abuse Its Discretion by Awarding No Damages on Plaintiffs' Unjust Enrichment Claim. 29

II. THE TRIAL COURT'S VALUATION FINDINGS ARE SUPPORTED BY THE RECORD. 31

A. Question Presented....31

B. Standard and Scope of Review 31

C. Merits of Argument....31

1. The Trial Court Properly Allocated the Burden of Proof. 31

2. The Trial Court's Finding that the Recapitalization Price Was Fair Because SMC's Equity Was Worthless Is Supported by the Record. 33

a. The Trial Court Correctly Valued SMC on a Standalone Basis Prior to the Recapitalization 35

b. The Record Supports the Trial Court's Rejection of Management Projections as Unreliable. 37

III. THE TRIAL COURT'S FINDING THAT PLAINTIFFS DID NOT PROVE ANY DISTINCT DAMAGES ON THEIR DISCLOSURE CLAIM IS SUPPORTED BY THE RECORD. 41

A. Question Presented....41

B. Standard and Scope of Review 41

C. Merits of Argument 41

IV. THE TRIAL COURT CORRECTLY HELD THAT THE PREFERRED A PLAINTIFFS LACKED STANDING. 43

A. Question Presented 43

B. Standard and Scope of Review 43

C. Merits of Argument 43

V. THE TRIAL COURT ABUSED ITS DISCRETION BY AWARDING PLAINTIFFS' COUNSEL $2 MILLION IN FEES AND EXPENSES. 46

A. Question Presented 46

B. Standard and Scope of Review 46

C. Merits of Argument 46

ARGUMENTS ON CROSS APPEAL 49

VI. THE TRIAL COURT ERRED BY NOT DISMISSING PLAINTIFFS' CLAIMS AS SOLELY DERIVATIVE. 49

A. Question Presented 49

B. Standard and Scope of Review 49

C. Merits of Argument 49

1. The Plaintiffs' Claims Are Not Direct Under *Gentile* 49

a. There Was No Corresponding Dilution. 51

b. There Was No Control Group Expropriation. 52

2. The Trial Court Erred in Applying *Carsanaro* 56

VII. THE TRIAL COURT ERRED IN AWARDING ATTORNEYS' FEES AND EXPENSES. 59

A. Question Presented 59

B. Standard and Scope of Review 59

C. Merits of Argument 59

1. Applying the Bad Faith Pre-Litigation Conduct Exception Should Have Led the Trial Court to Deny the Fee Petition. 59

2. The Trial Court's Development of a New Quasi-*Sugarland* Exception to the American Rule Was Error. 63

CONCLUSION 65

October 28, 2011 Memorandum Opinion ..... EXHIBIT A

TABLE OF AUTHORITIES

Cases

Americas Mining Corp. v. Theriault,
51 A.3d 1213 (Del. 2012) 24, 32, 64

Anadarko Petroleum Corp. v. Panhandle Eastern Corp.,
545 A.2d 1171 (Del. 1988) 43, 44

ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member LLC,
2013 WL 5152295 (Del. Ch. Sept. 16, 2013) ("*Scion II*") 60, 61

Aspen Advisors LLC v. United Artists Theatre Co.,
861 A.2d 1251 (Del. 2004) 44

Avacus Partners v. Brian,
1990 WL 161909 (Del. Ch. Oct. 24, 1990) 58

Bigelow v. RKO Radio Pictures,
327 U.S. 251 (1946) 29

Bomarko, Inc. v. International Telecharge, Inc.,
794 A.2d 1161 (Del. Ch. 1999) ("*Bomarko I*") 24, 25

Cantor Fitzgerald, L.P. v. Cantor,
2001 WL 536911 (Del. Ch. May 11, 2001) 62

Carsanaro v. Bloodhound Technologies, Inc.,
65 A.3d 618 (Del. Ch. 2013) 4

Cede & Co. v. Technicolor, Inc.,
758 A.2d 485 (Del. 2000) 31

Cinerama, Inc. v. Technicolor, Inc.,
663 A.2d 1156 (Del. 1995) 34, 41

Crothall v. Zimmerman,
94 A.3d 733 (Del. 2014) 48

Delaware Open MRI Radiology Associates, P.A. v. Kessler,
2006 WL 4764042 (Del. Ch. Apr. 26, 2006) 19, 35

DiRienzio v. Lichtenstein,
2013 WL 5503034 (Del. Ch. Sept. 30, 2013)..57, 58

Doft & Co. v. Travelocity.com, Inc.,
2004 WL 1152338 (Del. Ch. May 21, 2004) 37, 38

Dover Historical Society Inc. v. City of Dover Planning Commission,
902 A.2d 1084 (Del. 2006)..47, 59, 63

Feldman v. Cutaia,
951 A.2d 727 (Del. 2008) ("*Feldman II*")..49, 52, 56

Feldman v. Cutaia,
956 A.2d 644 (Del. Ch. 2007) ("*Feldman I*") 49, 50, 55, 57

Gatz v. Ponsoldt,
925 A.2d 1265 (Del. 2007)..57

Gentile v. Rossette,
906 A.2d 91 (Del. 2006)..3, 49-51, 56-58

Gesoff v. IIC Industries, Inc.,
902 A.2d 1130 (Del. Ch. 2006) 25

Goodrich v. E.F. Hutton Group, Inc.,
681 A.2d 1039 (Del. 1996)..64

Henne v. Balick,
146 A.2d 394 (Del. 1958)..29

Huff Fund Investment Partnership v. CKx, Inc.,
2013 WL 5861520 (Del. Ch. Oct. 31, 2013) 38

In re First Interstate Bancorp Consolidated Shareholder Litigation,
756 A.2d 353 (Del. Ch. 1999) 47

In re J.P. Morgan Chase & Co. Shareholder Litigation,
906 A.2d 766 (Del. 2006)..42, 55

In re Mobilactive Media, LLC,
2013 WL 297950 (Del. Ch. Jan. 25, 2013) 25-27

In re New Valley Corp. Derivative Litigation,
2004 WL 1700530 (Del. Ch. June 28, 2004) 51

In re Paxson Communication Corp. Shareholders Litigation,
2001 WL 812028 (Del. Ch. July 12, 2001) 52, 57

In re PNB Holding Co. Shareholders Litigation,
2006 WL 2403999 (Del. Ch. Aug. 18, 2006) 53, 54

In re Sauer-Danfoss Inc. Shareholders Litigation,
65 A.3d 1116 (Del. Ch. 2011) 47, 48

In re Trados Inc. Shareholder Litigation,
73 A.3d 17 (Del. Ch. 2013) 20, 32

In re Tri-Star Pictures, Inc. Litigation,
634 A.2d 319 (Del. 1993) 26, 41, 50, 51, 53, 54

In re Walt Disney Co. Derivative Litigation,
906 A.2d 27 (Del. 2006) 24

International Telecharge, Inc. v. Bomarko, Inc.,
766 A.2d 437 (Del. 2000) ("*Bomarko II*") 24-27

Kahn v. Tremont Corp.,
694 A.2d 422 (Del. 1997) 32

Kennedy v. Venrock Associates,
348 F.3d 584 (7th Cir. 2003) 54

LongPath Capital, LLC v. Ramtron International Corp.,
2015 WL 4540443 (Del. Ch. June 30, 2015) 38

Loudon v. Archer-Daniels-Midland Co.,
700 A.2d 135 (Del. 1997) 41,4 2

Montgomery Cellular Holding, Inc. v. Dobler,
880 A.2d 206 (Del. 2005) 34

Nemec v. Shrader,
991 A.2d 1120 (Del. 2010) 30

Oliver v. Boston University,
2000 WL 1091480 (Del. Ch. July 25, 2000) 52

ONTI, Inc. v. Integra Bank,
751 A.2d 904 (Del. Ch. 1999) 19, 35

Reis v. Hazelett Strip-Casting Corp.,
28 A.3d 442 (Del. Ch. 2011) 25, 29

Ryan v. Tad's Enterprises, Inc.,
709 A.2d 682 (Del. Ch. 1996) 48

Saliba v. William Penn Partnership,
2010 WL 1641139 (Del. Ch. Apr. 12, 2010)..21

Scion Breckenridge Managing Member LLC v. ASB Allegiance Real Estate Fund,
68 A.3d 665 (Del. 2013) ("*Scion I*") 60, 61

Simons v. Cogan,
549 A.2d 300 (Del. 1988)..44

St. Clair Shores Gen. Employees Ret. Sys. v. Eibeler,
745 F.Supp.2d 303 (S.D.N.Y. 2010) 52

Thorpe v. CERBCO, Inc.,
676 A.2d 436 (Del. 1996) 26, 27

Tooley v. Donaldson, Lufkin & Jenrette, Inc.,
845 A.2d 1031 (Del. 2004)..49, 50, 56

Turner v. Bernstein,
1999 WL 66532 (Del. Ch. Feb. 9, 1999)..57

Weinberger v. UOP, Inc.,
457 A.2d 701 (Del. 1983)..25, 27

William Penn Partnership v. Saliba,
13 A.3d 749 (Del. 2011) ("*Saliba II*").. 21, 60-61

Williamson v. Cox Communications, Inc.,
2006 WL 1586375 (Del. Ch. June 5, 2006) 53, 54

Court Rules

Supr. Ct. R. 8 29

Statutes

8 *Del. C.* § 228(e) 42

NATURE OF THE PROCEEDINGS

This case arises from the 2002 Recapitalization of SMC, a streaming media company then "running out of money." Op. 18.[1] The Recapitalization—specifically, two existing stockholders with Board representation contributing new money—enabled SMC to make two acquisitions that, over the course of nearly five years, brought it to breakeven, then profitability, and ultimately being acquired in a merger that valued SMC at $175 million. *Id.* at 18-52. "Almost all investors made a return on their initial investment," with the two stockholders who funded the acquisitions making, by far, the greatest returns. *Id.* at 5. In 2010, 43 former stockholders, later joined by six others, brought this action challenging the Recapitalization, seeking damages of over $130 million. *Id.* at 5-9.

After 11 days and over 3,000 pages of trial testimony, including from two valuation experts (not mentioned by Plaintiffs), as well as nearly 1,000 exhibits, the Court of Chancery ("Trial Court") issued a 146-page Opinion, in which it concluded that, while the process for approving the Recapitalization "was beyond unfair," the Recapitalization's price, "based on the only reliable valuation methodologies, was more than fair." *Id*. at 1. It found that "the Recapitalization, although it was approved and implemented at a fair price, was not entirely fair

[1] Defendants adopt the "Glossary of Abbreviations" in the Appellants' Opening Brief (the "Opening Brief" or "OB"). *See* OB viii. Otherwise, capitalized terms not defined herein or in the Glossary shall have the meaning ascribed to them in the Opinion.

because of the Defendants' grossly unfair dealing." *Id.* at 7. Given "the only reliable valuation evidence," it held that "the Defendants who breached their fiduciary duties or who aided and abetted those breaches are not liable for monetary damages." *Id.*

"[C]ontemplat[ing] one practicable" remedy for Defendants' conduct, the Trial Court granted Plaintiffs leave to file a fee petition. By letter opinion, it then determined that, notwithstanding that "Plaintiffs did not incur any out-of-pocket obligation to pay attorneys' fees because of the contingent nature of their fee arrangement," "Defendants' conduct warrants a shifting of fees." Fee Op. 6-7. Based on a newly-developed "quasi-*Sugarland* analysis" undertaken with "much room for doubt and second guessing," it awarded Plaintiffs $2 million. *Id.* at 11.

On appeal, while Plaintiffs herald the Trial Court's fact findings regarding the unfair process, they avoid its findings on the fairness of the price, the absence of any economic harm to Plaintiffs and the speculative nature of their proof. In fact, for each instance in which the court referred to the process as "beyond unfair" or "grossly unfair," it also labeled "the fair price of the Company's equity []as zero," Defendants' valuation evidence "as the only reliable valuation evidence" and Plaintiffs' damages proof as "too speculative." *Id.* at 1, 7, 114-15, 119, 130.

Plaintiffs ignore the court's valuation and damages findings and focus solely on its process findings, arguing that the Trial Court's finding of "grossly unfair"

conduct, without more, "compels" an "award [of] disgorgement or rescissory damages." OB 6. But the law is clear that the court has broad discretion in determining an appropriate remedy for breaches of fiduciary duty. Here, after noting that "Delaware courts have found [Plaintiffs'] damages theories to be appropriate in certain situations," the court "conclude[d], in its discretion, that it would be inappropriate to award disgorgement, rescissionary or other monetary damages to Plaintiffs 'because of the speculative nature of the proof offered." Op. 130-31. The court's fact findings are supported by the record, and it did not abuse its discretion in determining, based on those findings, not to award damages.

The court did err, however, in holding that Plaintiffs had standing to pursue direct claims, after noting that SMC's merger out of existence foreclosed them from pursuing derivative claims. Quoting *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006), the Trial Court observed that a "claim for 'expropriation' against [a] corporation's controlling stockholder could be asserted derivatively *and* directly" where the controlling stockholder, or a control group, causes the company to issue "excessive" shares of stock in exchange for consideration of lesser value, and the exchange causes the controlling stockholder's or control group's share percentage to increase "correspondingly" with the decrease in the minority stockholders' share percentage. Op. 58. It then misapplied *Gentile*. The court ignored that, for a direct claim, the control group must have expropriated a "corresponding" amount

of the minority stockholders' equity, which it found was absent here. It also applied an unprecedentedly broad standard to determine that, due to an unexercised right to participate in the Recapitalization, a stockholder diluted to the exact same extent as certain Plaintiffs formed part of a control group. Also, its finding that the Recapitalization's price was fair means that SMC did not issue "excessive" shares.

Additionally, the court erroneously adopted the alternative test for standing in *Carsanaro v. Bloodhound Technologies., Inc.*, 65 A.3d 618 (Del. Ch. 2013), which identified a new class of direct claims when a majority of the directors "had the ability to use the levers of corporate control to benefit themselves" and "took advantage of the opportunity." Op. 71, 73. The court's rulings expanded the exception to the continuous ownership rule to the point of elimination. The Plaintiffs have no standing, and all of their claims should have been dismissed.

The Trial Court also erred by granting Plaintiffs a fee award of $2 million. The sole grounds for invoking fee shifting as a potential remedy—the pre-litigation bad faith exception to the American Rule, *id.* at 131—does not apply. That exception is designed to compensate plaintiffs for incurring the expense of proving bad faith breaches of fiduciary duty, but Plaintiffs incurred no fees or expenses due to their completely contingent fee arrangement. The court's development of what the Plaintiffs themselves describe as "a novel, litigation-recovery-range analysis," OB 5, was antithetical to Delaware law and sound policy, and should be reversed.

SUMMARY OF ARGUMENT

1. Denied. The Trial Court was not "compelled" to award disgorgement or rescissionary damages, and did not abuse its discretion in not doing so after finding, among other things, that Plaintiffs' pre-Recapitalization equity had no value, the Recapitalization was "effected at a fair price," and Plaintiffs' proof in support of their damages theories was "too speculative."

2. Denied. The Trial Court's fact findings, based partly on credibility determinations, that Plaintiffs' pre-Recapitalization equity had no value, the Recapitalization was "effected at a fair price," and Plaintiffs' proof in support of their damages theories was "too speculative" are supported by the record.

3. Denied. The Trial Court did not abuse its discretion in awarding no damages on Plaintiffs' disclosure claim, as the court found that Plaintiffs had failed to prove that the misleading disclosure of stockholder action following the Recapitalization resulted in any harm to Plaintiffs distinct from that suffered as a result of the Recapitalization itself, which the court found to be nonexistent.

4. Denied. The Trial Court correctly held on summary judgment that the Preferred A Plaintiffs, who were not SMC stockholders when the Recapitalization was approved and implemented, were not owed fiduciary duties. Moreover, to the extent the Trial Court's determination that all Plaintiffs are not entitled to damages is affirmed, the Preferred A Plaintiffs' standing is academic.

5. Agreed that the Trial Court abused its discretion by awarding Plaintiffs' counsel $2 million in fees and expenses, but otherwise denied. The court correctly rejected Plaintiffs' attempt to recover over $11.4 million in legal fees and expenses on a *quantum meruit* basis where Plaintiffs' counsel was engaged on a completely contingent basis and recovered nothing for Plaintiffs.

6. Rather than recognizing Plaintiffs' claims to be derivative and dismissing them under the continuous ownership rule, the Trial Court erred in holding that Plaintiffs' claims are direct under *Gentile*, which applies when a controlling stockholder expropriates excessive shares resulting in a corresponding dilution to minority stockholders. It disregarded the lack of correspondence between the dilution of the minority stockholders and the equity issued to Wren and Javva. The court also applied the wrong legal standard in determining that Wren, Javva, and Catalyst comprised a control group, the functional equivalent of a controlling stockholder and overlooked that its fair price finding defeated any claim of excessive share issuance. Finally, the Trial Court erred by following *Carsanaro*, which effectively eviscerates the continuous ownership rule.

7. The Trial Court also erred by, in its own words, "test[ing] the range of equity's powers" in applying a novel "*quasi*-Sugarland" test to award attorneys' fees unsupported by any applicable exception to the American Rule and that, absent any compensatory purpose, were punitive in nature.

FACTS

A. The Genesis and Approval of the Recapitalization

From its inception in 1999, SMC, despite its early optimism and promise, was plagued with "disruptive cash flow problems that threatened its continued existence." Op. 12-13. Its principal investors were Wren, Javva, Catalyst (none of which had any historical or material relationship with one another) and non-party Lipper. *Id.* at 10-11, 62. "Lipper" consisted of individual investors (most of whom are Plaintiffs) who had been introduced to SMC by non-party Biderman, then a partner at Lipper & Co. *Id.* at 3, 11.

By spring 2001, SMC's "financial troubles necessitated additional funding." Summary Judgment Mem. Op. dated Feb. 28, 2013 ("SJ Op.") at 4. Unable to raise outside capital, Wren, Javva, Catalyst and several Plaintiffs purchased SMC secured debt, consisting of notes with warrants convertible into common stock. *Id.* at 4-5. Even so, SMC "continued to struggle to pay its bills." *Id.* at 5.

Around the time of the debt offering, SMC's founding CEO was replaced by Williams, who then joined Wren's Cameron, Javva's Katz, Catalyst's Shipman and Lipper's Biderman on the Board. Op. 2-3, 17-18. Williams continued his predecessor's efforts to explore SMC's possible acquisition of e-Media (a competitor) and NaviSite (the owner of a streaming media software platform known as Stream OS). *Id.* at 17-18. Both targets had stronger revenues and cash

flows than did SMC. *Id.* at 18. Williams hoped the acquisitions would boost SMC's "revenues to positive, or at least to breakeven." *Id.* at 19.

By December 2001, SMC was again "running out of money" and "facing what [its] CFO Granberg described as 'panic.'" *Id.* at 18. After a meeting the court found was scheduled for a time when Biderman could not attend, Williams asked Wren's Dwyer to devise a plan to fund SMC's acquisitions of e-Media and NaviSite to "stay alive." *Id.* at 20. Dwyer alone conceived the Recapitalization, which consisted of two parts: (i) exchanging SMC's existing secured debt for preferred stock; and (ii) issuing additional preferred stock for the new capital that would finance the acquisitions. *Id.* At the time, Wren, Javva and Catalyst collectively owned about 54% of SMC's stock and held over 90% of SMC's secured debt; Plaintiffs collectively held about 26% of SMC's stock. *Id.* at 18.

After Bideman learned about the Recapitalization proposal from Dwyer, he sent the Board a "harshly worded objection" expressing his "dissatisfaction" with "unfair dilution" that would result from the plan. *Id.* at 20-21. The Board did not respond to the letter, but did hold three meetings in January (attended by Biderman) to consider the acquisitions and plan to fund them. The court found that (between meetings) some Defendants met informally without Biderman to "hammer out" details of the Recapitalization. *Id.* at 24-27.

On January 7, 2002, Dwyer presented his $4 million valuation of SMC to the

Board. *Id.* at 22-23. The Trial Court had no "doubt that Dwyer believed this valuation was appropriate." *Id*. at 23 n.71. Yet Dwyer did not share his valuation methodology. *Id.* at 22-23. Nor did the Board obtain an independent valuation. *Id.* at 3. Without "understanding. . . how Dwyer came to value" SMC at $4 million, four directors voted for the Recapitalization, but Biderman abstained, citing the plan's dilutive effect. *Id*. at 23-24.

At the Board's January 10 meeting, Williams told the Board that SMC "was no longer a viable stand-alone entity," and that the Board had only two options: (i) acquire e-Media and NaviSite, or (ii) undertake "a complete liquidation of the business." *Id.* at 24-25. Williams distributed a *pro forma* revenue projection for 2002 that predicted revenues for a combined company of about $16 million, with just over $7 million coming from legacy SMC and just under $9 million to be generated post-acquisition by e-Media and NaviSite. *Id*. at 31.

Wren and Javva agreed to contribute $2 million and $500,000, respectively, of the amount Williams said would be needed to fund the acquisitions. *Id.* at 26. They did so because they "suffered from the sunk cost fallacy," and believed they "had the 'most to lose' if the Company failed." *Id*. "Shipman and Catalyst, on the other hand, were aware of what it meant to 'throw good money after bad,'" and declined to participate, as did Lipper. *Id.* at 26-27. "Williams believed that Wren, Javva, and Catalyst each 'made independent decisions for themselves.'" *Id.* at 26.

The Board approved the acquisition-related borrowing, with Biderman dissenting again on the grounds of dilution. *Id.* at 27. Based on two internal Catalyst documents dated days after the January 10 meeting, the Trial Court found it "more likely than not" that Wren and Javva "informally extended to Catalyst. . . an invitation to participate in this $2.5 million financing on the same terms for ninety days after the closing of the e-Media and NaviSite[] acquisitions." *Id.* at 29.

On January 17, the full Board met again to discuss revising the Recapitalization plan to address Biderman's concerns. *Id.* at 30. Under a revised proposal, the equity share to be held by SMC's existing stockholders would be reduced to about 7% (versus 3% in the January 10 proposal) and SMC's secured debt would be exchanged for Preferred A stock equating to roughly 20% of SMC. *Id*. at 30-31. The "new money" would receive Preferred B stock. *Id.* Biderman again objected to the dilution, but "to make the best out of the situation," agreed to vote for the Recapitalization on two conditions. *Id.* at 32. The Board unanimously approved the Recapitalization on Biderman's conditions. *Id.*

B. Events Prior to Closing the Recapitalization

The e-Media acquisition closed that day. *Id.* at 33. SMC paid $1 million cash plus a $3.6 million note convertible to 15.8% of SMC's equity, subject to downward adjustment if the acquired assets generated less revenue than projected. *Id.* The NaviSite closing, however, was postponed several times. *Id*. By late

February, SMC needed $2.6 million to complete that acquisition. *Id.* Eventually, the total needed to fund both acquisitions rose to $3.3 million, all of which Wren and Javva agreed to contribute. *Id.* at 33-34. Conversion of their contributions into equity, however, was conditioned on "persuad[ing] 100% of the holders of its senior debt to exchange their notes into equity." *Id.* at 39. Thus, "the holders of the senior debt appear to have had veto power over the debt-to-Preferred-A-stock exchange." *Id.* at 40.

SMC's financial struggles continued even after it acquired NaviSite on March 25, 2002. *Id.* at 36. By April 2002, SMC "faced a $1 million cash shortfall" due to "persistent revenue problems," partly because e-Media "was not performing as projected." *Id.* at 37. Wren and Javva each agreed to loan SMC another $400,000, thereby reducing SMC's shortfall to $200,000. *Id.*

In May, Snyder, who joined SMC as part of the NaviSite acquisition and who "proved to be a 'very capable' manager," was appointed as CEO and as a director, replacing Williams who had resigned in April "most likely at Wren's request." *Id.* at 37-38. Snyder signed the promissory notes regarding Wren and Javva's $3.3 million investment. *Id.* at 38-39. The Trial Court found that, without Board approval, certain terms of those notes were later changed, and limitations in the notes not enforced, to Wren's and Javva's advantage. *Id.* at 39.[2]

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[2] Plaintiffs "waived" any claim related to those changes, and any other changes to the terms of

C. Closing the Recapitalization

The Recapitalization fully closed in August 2002 without Catalyst ever exercising its 90-day right to invest. *Id.* at 40, 42. In early August, the Board acted by unanimous written consent to authorize amending SMC's charter to effect a 1:20 reverse stock split and to create the Preferred A, B-1 and B-2 stock. *Id.* at 41. Wren, Javva and Catalyst (who together owned a majority of SMC's common stock) executed written consents necessary to approve the amendments. *Id.*

Because e-Media's 2002 revenues were "lower-than-expected," SMC exercised the adjustment feature in the e-Media note and issued 2.6% of its total equity—in the form of Preferred B-2 stock—to e-Media's former owner. *Id*. at 42. The Preferred A stock (now representing 23% of SMC's total equity) was issued to all holders of SMC's secured debt (including certain Plaintiffs) in exchange for their notes and warrants. *Id*. at 41. The Preferred B-1 stock (now representing approximately 51% of SMC's total equity) was issued to Wren and Javva in exchange for the $3.3 million they contributed so that that SMC could pay for the acquisitions. *Id.* at 42. In total, about 5% of the new equity issued in the Recapitalization went to non-Defendants. SJ Op. 16.

Once the Recapitalization was effected, Wren held 54% and Javva held 17% of SMC's total equity. Op. 43. Catalyst's equity was diluted to 9%, *id*., down

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the Recapitalization between January and August 2002, because they "did not contest the post-January value of [SMC]. . . in their post-trial briefing." Op. 116.

from over 21% before the Recapitalization. B5. Those Plaintiffs who owned both common stock and senior debt were diluted to the same extent as Catalyst. Overall, Plaintiffs' equity (excluding the Preferred A Plaintiffs, who were not stockholders before the Recapitalization) was reduced from 26% to 2%. Op. 43.

D. Post-Recapitalization Events

After the Recapitalization was completed, Dwyer and Snyder prepared the Fall 2002 Update ("likely" with "the advice of counsel") that SMC sent to its stockholders in an effort to comply with its duty to provide notice of the corporate action taken by written consent in August 2002. *Id.* at 44, 93. The Trial Court concluded that the update "was materially misleading" because, while it generally described details of the Recapitalization, it "failed to disclose who participated in the Recapitalization or on what terms." *Id.* at 44-45, 93-94.

Based on the Fall 2002 Update and various other communication failures, the court concluded that "Defendants on the Board sought to avoid full and fair communications with the Company's stockholders." *Id.* at 46. Rather than malice or avarice, however, the court attributed the "overall failure to communicate" in part to the Board's "mistaken belief"—shared by each of the directors, including Biderman—"that each director representative was responsible for his affiliated investors," such that "the responsibility to inform the Lipper-affiliated stockholders (*i.e.*, most of the Plaintiffs) fell exclusively to. . . Biderman." *Id.* at 46 & n.174.

For years after the Recapitalization, the Company continued to struggle. *Id.* at 47. For example, Snyder asked management to defer their paychecks in 2004; Wren, Javva, and Dwyer made multiple additional loans to the Company; and the Company did not post its first annual profit until the year ended June 30, 2006. *Id.* Throughout this time period, "the Company had sporadic, if any, communications with most of its stockholders." *Id.* at 4. "Some stockholders may have been notified of certain of these" developments, but not more than once per year. *Id.* "There were no annual meetings or director elections." *Id.*

After the Company received expressions of interest in late August 2006, merger negotiations ensued, with Akamai emerging as the high bidder. *Id.* at 50. On December 13, 2006, Akamai acquired the Company in a stock-for-stock merger that valued it at approximately $13 per share (roughly $175 million). *Id.* at 50-52. "[T]he trial record strongly suggests that it was Snyder's management of NaviSite['s] Stream OS business—not the Company's legacy business—that drove the Company's growth after the Recapitalization" and ultimately led to the Akamai Merger. *Id.* at 130; *accord id.* at 47. "Almost all investors made a return on their initial investment in" SMC, including Plaintiffs. *Id.* at 5. Defendants received approximately $150 million, and the Plaintiffs approximately $3 million, of the merger consideration. *Id.* at 52.[3]

[3] The $3 million total recited in the Opinion does not include the Preferred A Plaintiffs, whose

In August 2008, two former stockholders filed a putative class action against Defendants. Op. 8. After denial of class certification, in November 2010, 43 former stockholders filed individual claims. *Id.* The court granted summary judgment dismissing the claims of the Preferred A Plaintiffs in February 2013. *Id.* at 9. In October 2012, six additional plaintiffs filed claims, two of whose claims were dismissed. *Id.* Plaintiffs' claims for breaches of fiduciary duty based on expropriation and disclosure, aiding and abetting breaches of fiduciary duty, and unjust enrichment were tried over 11 days in December 2013. *Id.* at 5. The court issued its Opinion on September 4, 2014, and its Fee Opinion on May 7, 2015.

E. The Opinion

1. Conclusions on Standing

The Trial Court recognized that, after the Akamai Merger, Plaintiffs had standing to assert only direct claims. Op. 54. Quoting *Gentile*, the court identified "at least one transactional paradigm. . . that Delaware case law recognizes as being both derivative and direct in character," namely where (i) a controlling stockholder, or its functional equivalent, causes the corporation to issue "excessive" shares for less than adequate consideration, and (ii) the controlling stockholder's share percentage increases by an amount "corresponding" to the decrease in the minority stockholders' percentage. *Id.* at 57-58.

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claims were dismissed on summary judgment for lack of standing. SJ Op. 19-22. They received approximately $2.7 million of the merger proceeds. *See* B10-13.

The court addressed the second criterion first, acknowledging that the "Recapitalization did not increase Wren and Javva's ownership of [SMC] 'to the same extent' that it diluted Plaintiffs' equity." *Id*. at 59. However, it held without elaboration that this fact did "not change the Court's conclusion that the Recapitalization may have given rise to direct and derivative harm." *Id.*

Instead, the court focused primarily on whether Plaintiffs had proved that Wren, Javva and Catalyst comprised a control group (i.e., the "functional equivalent of a controlling stockholder"). *Id.* at 60, 66. The court held that Catalyst's 90-day "right to invest demonstrates that Wren, Javva, and Catalyst were a control group," because (i) "a right to invest was provided only to Catalyst, whose consent would be necessary to approve certain charter amendments"; (ii) "Wren and Javva must have together decided to provide it to Catalyst during one of the informal telephone meetings"; and (iii) "the right to invest was not disclosed to the entire Board." *Id.* at 64. It concluded that "the weight of the evidence supports the inference that, in exchange for agreeing to support the Recapitalization through Shipman's votes on the Board and Catalyst's stockholder written consent, Catalyst received the 90-day right to invest in the Recapitalization," thereby demonstrating a control group. *Id.* at 65.

The Trial Court further addressed whether Plaintiffs also had standing under *Carsanaro*. *Id.* at 69. While acknowledging that *Carsanaro* might "exceed what

the Delaware Supreme Court intends in this area of Delaware law," the court agreed with *Carsanaro* that a direct claim exists "when defendant fiduciaries (i) had the ability to use the levers of corporate control to benefit themselves, and (ii) took advantage of the opportunity." *Id.* at 73. The court thus held, in the alternative, that Plaintiffs had standing because "a majority of the Board was conflicted. . . when it approved and implemented the Recapitalization." *Id.*

2. Conclusions on Entire Fairness

a. Fair Dealing

The Trial Court next concluded that, while the "general initiation" of the Recapitalization had been fair, "the specific sequence of events undertaken by the Defendants to implement the Recapitalization was not fair." *Id.* at 88. It cited that: (i) Biderman "was knowingly excluded from at least one Board meeting, unaware of informal calls among directors. . . , and not provided with important materials"; (ii) the Board was not adequately informed about the basis for Dwyer's $4 million valuation; (iii) Catalyst received an undisclosed right to invest; and (iv) the terms of the Wren and Javva promissory notes were changed to their benefit. *Id.* at 88-95. The court also found "powerful evidence of unfair dealing" in the failure of the Fall 2002 Update to disclose material information. *Id.* at 94.

b. Fair Price

The court wrote tens of pages contrasting the analyses and opinions of Plaintiffs' expert, Reilly (an investment banker), with that of Defendants' expert,

Hausman (a chaired MIT professor of economics). *Id.* at 96-97. The experts' opinions were particularly significant because the court found that "none" of the so-called contemporaneous statements of value on which Plaintiffs relied at trial was credible. Op. 97-107.

In particular, the court found that Defendants "successfully demonstrated that management's projections were wholly unreliable." *Id.* at 104. It agreed with Hausman that the table below "conclusively demonstrates" that SMC's "management was unable to produce reliable projections":

2001 Revenue: Projections v. Actual					
Month	Jan. 2001 Projections	Mar. 2001 Projections	June 2001 Projections	Daniels Memo	Actual
January	180,001	--	--	--	42,797
February	250,000	--	--	--	66,534
March	386,437	62,211	--	--	68,079
April	544,936	79,703	--	--	83,955
May	732,313	98,020	--	--	95,867
June	808,655	128,986	128,105	--	78,235
July	912,103	167,536	153,885	--	78,351
August	1,063,032	209,432	204,885	--	70,130
September	1,274,326	270,088	297,135	98,575	74,218
October	1,547,858	354,244	358,510	130,300	77,166
November	1,896,714	450,618	414,010	176,838	69,750
December	2,328,526	549,330	469,510	241,500	71,673

Id. at 104-06. It specifically rejected the pro forma projections given to the Board in January 2002: "The Court cannot accept that the same people who missed projections three-months out in September 2001 by a factor of three (where there was no intervening change to the Company's business) would have been able to produce reliable projections in January 2002 for an entire year." *Id.* at 106-07.

As such, the Trial Court did not accept Reilly's analysis, which hinged entirely on the unreliable projections. *Id.* at 107, 109-10, 114-15. It also rejected Reilly's analysis because he added the value of e-Media and NaviSite to his valuation of SMC as of the Recapitalization's approval. *Id.* at 99-101, 110. (Reilly never opined what SMC was worth without e-Media and NaviSite. *Id.*) The Trial Court, however, concluded that, in contrast to *ONTI, Inc. v. Integra Bank*, 751 A.2d 904 (Del. Ch. 1999), and *Delaware Open MRI Radiology Assocs., P.A. v. Kessler*, 2006 WL 4764042 (Del. Ch. Apr. 26, 2006), "neither proposed acquisition was within the Company's financial ability to capture." Op. 101. Rather, it was the "new money" alone that financed the acquisitions. *Id.*

The Trial Court thus found that "the only credible valuations available" were Hausman's, which it "credit[ed]" as "persuasive." *Id.* at 104, 114-15. The court agreed with Hausman that, because management's projections were historically unreliable and SMC "did not have any earnings or positive cash flow" when the Recapitalization was approved, the "best method" to value SMC was "based on last twelve months ('LTM') revenue multiples for comparable companies.'" *Id.* at 110. Noting that the experts agreed on several of the comparable companies, the court found Hausman's comparable companies to be "appropriate for his valuations," and accepted the 20% private company discount he applied. *Id.* at 112-13. After applying to SMC's revenues as of approval of the Recapitalization

the LTM multiples not just that Hausman, but also Reilly, used, and then subtracting SMC's existing debt, the Trial Court arrived at a range of equity values for SMC of between *negative*-$4,329,074 and *negative*-$1,753,606. *Id.* at 114.

Thus, the Trial Court concluded that SMC's equity value "before the Recapitalization was $0." *Id.* at 115. Accordingly, the court held that the Recapitalization had been approved at a fair price: "Regardless of how much the Plaintiffs may have been diluted in the Recapitalization, because their common stock had no value that could have been diluted, the Plaintiffs necessarily 'received the substantial equivalent in value of what they had before.'" *Id.* at 115-16.

c. Unitary Fairness

The Trial Court specifically contrasted its unitary fairness determination with the then-recent decision in *In re Trados Inc. Shareholder Litig.*, 73 A.3d 17 (Del. Ch. 2013), in which the Court of Chancery concluded that a transaction effectuated through a decidedly unfair process was entirely fair because the subject company's equity had no value. The Trial Court made clear that it "does not interpret *Trados* for the broad proposition that a finding of fair price, where a company's common stock had no value, forecloses a conclusion that the transaction was not entirely fair." Op. 118. Instead, it expressed reluctance "to conclude that the Recapitalization, even if it was conducted at a fair price, was an entirely fair transaction because of the grossly inadequate process employed by the

Defendants." *Id.* "After a careful and reflective weighing" of factors, the Trial Court concluded that the Defendants had breached their fiduciary duties because the Recapitalization was not entirely fair. *Id.* at 120.

d. Damages

While acknowledging its "very broad" discretion to fashion relief, which is even greater "when fashioning an award of damages in an action for a breach of the duty of loyalty," the Trial Court held "in its discretion, that it would be inappropriate to award disgorgement, rescissionary, or other monetary damages to the Plaintiffs." *Id.* 129-31. Among the factors cited for so exercising its discretion were: (i) "the $4 million value attributed to [SMC] in the Recapitalization was at a fair price"; (ii) Defendants had "no duty to allow the Plaintiffs to participate" in the Recapitalization; (iii) "calculating damages for a lost opportunity to invest is too speculative based on the facts and circumstances here"; and (iv) but for the Recapitalization, "little evidence" suggests SMC would have been worth "any amount approaching" what Plaintiffs sought in damages. *Id.* at 129-30.

The Trial Court went on to observe, however, that just because Plaintiffs were not entitled to damages did not leave them "wholly without a remedy." *Id.* at 131. The court invited briefing on whether the case might qualify for fee shifting under *Saliba v. William Penn P'ship*, 2010 WL 1641139 (Del. Ch. Apr. 12, 2010), *aff'd*, 13 A.3d 749 (Del. 2011) ("*Saliba II*"), from which the Court quoted, "it

would be unfair. . . to require plaintiffs to shoulder the costs incurred in demonstrating the unfairness of the Recapitalization." Op. 131-32 & n.432.

3. Conclusions as to Other Claims

The Trial Court held that Plaintiffs had not proved any damages on their non-disclosure claim separate from the damages they alleged as a result of the Recapitalization. *Id*. at 93 n.325. Thus, it considered the disclosure claims "in the context of the entire fairness analysis." *Id*. It further noted that Plaintiffs' unjust enrichment claim would "lead to the same recovery" ($0) as their claim for breach of fiduciary duty. *Id.* at 126. It therefore did not decide the claim other than to note that "it would appear difficult for the Plaintiffs to establish an impoverishment" in light of the court's valuation findings. *Id.* at 126 n.416.

F. The Fee Opinion

The Trial Court observed that due to their contingent fee arrangement, Plaintiffs neither paid nor were obligated to pay any of the $11,427,195.23 in fees and costs accrued by their lead counsel. Fee Op. 2-3.[4] Nonetheless, the court found that the circumstances of the case supported equitable fee shifting because otherwise counsel's efforts would be reduced to "the functional equivalent of a charitable undertaking," and "Defendants who rightfully ought to owe Plaintiffs' attorneys' fees" would "be able to avoid their obligations." Fee Op. 6-7.

[4] Plaintiffs' Delaware counsel was paid in full by lead counsel. A684.

Acknowledging that the "common fund and corporate benefit exceptions" to the American Rule "do not directly apply here," the court invoked the pre-litigation bad faith exception. *Id.* at 4 n.12. Eschewing "substantial authority indicating that such exception is limited to cases of 'intentional misconduct,'" the court viewed its equitable powers "more broadly." *Id.* Invoking "context," the court was "satisfied that Defendants' pre-litigation conduct qualifies" for the exception. *Id.* at 6.

As to amount, the Trial Court found the $11.4 million sought by Plaintiffs' counsel to be "disproportionate and plainly excessive" in relation to the $3-4 million recovery the court hypothesized might reasonably have been anticipated before trial. *Id*. at 8. However, while acknowledging that the quantifiable value of the benefit achieved in the litigation was $0, the court viewed the litigation as having "vindicated certain important rights," and thus found "[s]ome fee" to be warranted. *Id*. at 9-10. Conceding that "any fee [it awarded] would be speculative and uncertain" and subject to "much room for doubt and second guessing," the Trial Court posited what it referred to as a "quasi-*Sugarland* analysis." *Id*. Assuming "a reasonable pre-ligation recovery range" of $7-10 million, and "discount[ing] it based upon the ultimate failure to recover any damages," the court awarded Plaintiffs' counsel $2 million in legal fees and expenses. *Id.* at 9-11.

For the reasons set forth herein, the Opinion and Fee Opinion should be reversed, and the entire action should be dismissed.

ARGUMENTS ON APPEAL

I. THE TRIAL COURT DID NOT ABUSE ITS DISCRETION BY NOT AWARDING DISGORGEMENT OR RESCISSIONARY DAMAGES.

A. Question Presented

Did the Trial Court abuse its discretion by not awarding disgorgement or rescissionary damages after finding, among other things, that Plaintiffs' equity had zero value, the price paid in the Recapitalization was fair, and Plaintiffs' proof in support of their damages theories was too speculative? B188-90; B309-10.

B. Standard and Scope of Review

Whether the Trial Court was required to award disgorgement or rescissionary damages is a question of law reviewed *de novo*. *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 48 (Del. 2006). If the court was not so required, then its decision not to award either remedy is reviewed for abuse of discretion. *Int'l Telecharge, Inc. v. Bomarko, Inc.*, 766 A.2d 437, 440 (Del. 2000) ("*Bomarko II*"), *aff'g* 794 A.2d 1161 (Del. Ch. 1999) ("*Bomarko I*"). An exercise of the Trial Court's discretion will be upheld if it "was the product of reason and conscience" as opposed to having been "arbitrary and capricious." *Ams. Min. Corp. v. Theriault*, 51 A.3d 1213, 1262 (Del. 2012).

C. Merits of Argument

1. Whether to Award Disgorgement or Rescissionary Damages Is Left to the Discretion of the Trial Court.

Plaintiffs' main argument on appeal is that the Trial Court's finding of a

"grossly inadequate process" "required disgorgement" of Defendants' profits (allegedly $118.6 million), or alternatively rescissionary damages of at least $17.8 million. OB 14. Plaintiffs' contention is contrary to settled law.

As the Trial Court recognized and the cases that Plaintiffs cite confirm, OB 16; Op. 129, the Court of Chancery has broad discretion to determine the appropriate remedy under the entire fairness standard. *See Bomarko II*, 766 A.2d at 439 ("we defer substantially to the discretion of the trial court in determining the proper remedy. . . to be awarded for a found violation of the duty of loyalty"); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983) (holding the Court of Chancery's "powers are complete to fashion any form of equitable and monetary relief as may be appropriate"); *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1154 (Del. Ch. 2006) ("significant discretion is given to the court in fashioning an appropriate remedy"); *Reis v. Hazelett Strip-Casting Corp*., 28 A.3d 442, 466 (Del. Ch. 2011) (same); *Bomarko I*, 794 A.2d at 1184 (same). None of the cases cited by Plaintiffs hold that the court's discretion ends with a finding of unfairness. Indeed, *Bomarko II* rejected that very argument. 766 A.2d at 441-42 (finding "unconvincing" and "not supported by Delaware law" the argument that the "Court of Chancery had no discretion to do anything but order disgorgement").

Plaintiffs' reliance on *In re Mobilactive Media, LLC* is misplaced. OB 15. That decision merely restates the settled rule in corporate opportunity cases that the

breaching party "must disgorge all profits and equity from the usurpation." 2013 WL 297950, at *23 (Del. Ch. Jan. 25, 2013). Another of Plaintiffs' cases likewise applies the corporate opportunity doctrine. *See Thorpe v. CERBCO, Inc.*, 676 A.2d 436, 445 (Del. 1996) (quoting *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319, 334 (Del. 1993)); *cf. Bomarko II*, 766 A.2d at 442 (criticizing reliance on "*Thorpe* for the proposition that the court's finding of a breach of the duty of loyalty required disgorgement"). Thus, Plaintiffs' contention that the Trial Court was "compelled" to award disgorgement or rescissionary damages is without merit.

2. The Trial Court Did Not Abuse Its Discretion by Not Awarding Disgorgement or Rescissionary Damages.

Plaintiffs' attack on the Trial Court's decision not to award damages thus boils down to a disagreement with the outcome of the court's deliberations, not legal error. The court's exercise of discretion was well reasoned and supported by the record and did not constitute an abuse of discretion.

In rejecting disgorgement and rescissionary damages, the Trial Court acknowledged both (i) its "'very broad' power to 'fashion[] equitable and monetary relief,'" particularly "when fashioning an award of damages in an action for a breach of the duty of loyalty"; and (ii) that "Delaware courts have found [Plaintiffs'] damage theories to be appropriate in certain situations." Op. 129. Yet it concluded, "in its discretion," that "it would be inappropriate to award disgorgement, rescissionary or other monetary damages to the Plaintiffs" here. *Id.*

at 130-31. It based that conclusion on its fact findings that: (i) Plaintiffs suffered no economic harm in the Recapitalization; (ii) Plaintiffs' evidence of incidental damages arising from the Recapitalization (*i.e.*, additional Akamai Merger proceeds Plaintiffs claimed they would have received) was unfounded because Defendants had "no duty to allow Plaintiffs to participate" in the transaction; (iii) "calculating lost opportunity to invest is too speculative"; and (iv) "but for the [Recapitalization] there is little evidence to suggest that the Company would have been worth any amount approaching" Plaintiffs' claimed damages. *See supra* Facts, Section E.2.d. Plaintiffs do not, and cannot, contend that these findings were clearly wrong.

The cases Plaintiffs cite in which the Court of Chancery incorporated disgorgement or rescissionary damages into an award involved different circumstances from those here. Each involved diversions of corporate opportunities away from the corporation or misleading pre-transaction communications that induced stockholders to forfeit rights. *See*, *e.g.*, *Bomarko II*, 766 A.2d at 440-41 (affirming award of rescissory damages where fiduciary concealed and diverted a corporate opportunity prior to a merger); *Thorpe*, 676 A.2d at 445 (holding plaintiffs entitled to "damages incidental to [the] breach" under the corporate opportunity doctrine); *Weinberger*, 457 A.2d at 714 (remanding for damages findings where stockholders were induced to tender

shares at a fair price based on misleading communications); *Mobilactive*, 2013 WL 297950, at *23 (awarding profits defendants unjustifiably received by usurping corporate opportunities). No similar circumstances are present here. The court found Plaintiffs' equity was worthless; the Recapitalization was carried out a fair price; and Wren and Javva did not usurp the opportunity to purchase e-Media and NaviSite, but rather made it possible for SMC to exploit that opportunity.

Plaintiffs also mischaracterize the record when they imply that the court abused its discretion by not awarding damages despite supposedly finding "that rescissory damages for Defendants' breaches at a minimum would be 'approximately $17.8 million, plus interest." OB 17. The court did not "*actually quantif[y]*" rescissory damages. *Id*. at 20. Rather, the court described Plaintiffs' $17.8 million damages theory as the "most compelling" of their theories. Op. 129. As with each of Plaintiffs' damages theories, the court rejected this theory, finding "Defendants were under no duty to allow the Plaintiffs to participate," and, "furthermore, calculating damages for a lost opportunity to invest is too speculative based on the facts and circumstances here." *Id.* at 129-30.

Further, Plaintiffs misstate the law by arguing that even if an award of disgorgement or rescissionary damages were speculative, such damages are still warranted because "*Defendants*, not *Plaintiffs*, 'bear the risk of th[is] uncertainty.'" OB 17. While case law recognizes that "justice and public policy require that the

wrongdoer shall bear the risk of the uncertainty which his own wrong has created," the same authority states that "even where the defendant by his own wrong has prevented a more precise computation, the [fact finder] may not render a verdict based on speculation or guesswork." *Bigelow v. RKO Radio Pictures,* 327 U.S. 251, 265 (1946); *accord Henne v. Balick*, 146 A.2d 394, 396 (Del. 1958); *Reis*, 28 A.3d at 466. Here, the Trial Court did not find that uncertainties in Plaintiffs' proof prevented the *computation* of damages. Rather, after weighing the evidence, it found that Plaintiffs failed to prove the *existence* of any damages.

Plaintiffs also ascribe error to the court for failing to award damages to which they claim they were "entitled. . . for at least three discrete harms." OB 20-21 (citing Op. 39). However, because Plaintiffs never asserted or requested any of these post-January 2002 damages theories in their post-trial briefing, Op. 116; *see* A555-57, they waived any right to seek them now. Supr. Ct. R. 8. In any event, the "discrete harms" Plaintiffs now seek to remedy each appear to pertain to discrete derivative claims that were never pled.

3. The Trial Court Did Not Abuse Its Discretion by Awarding No Damages on Plaintiffs' Unjust Enrichment Claim.

Plaintiffs also contend they are not foreclosed from recovering disgorgement damages on their unjust enrichment claim merely because the court found damages to be "unavailable" on their breach of fiduciary duty claims. OB 21-22. The court, however, did not find damages to be unavailable; it found that damages were non-

existent. The Trial Court reasoned that "Plaintiffs' claim for unjust enrichment. . . mirrors their claims for breach of fiduciary duty," in that "[t]he theories of liability are the same"; "[t]he elements of proof are the same, and so are the possible recoveries"; thus, a finding of no damages on the breach of fiduciary duty claim would necessitate the exact same finding on the unjust enrichment claim. Op. 125. It therefore concluded that it did not need to "address th[e] unjust enrichment claim," since "if resolved in [Plaintiffs'] favor, [it would] lead to the same recovery" as the breach of fiduciary duty claim—*i.e.*, zero. *Id.* at 126.

In any event, given the Trial Court's factual findings that Plaintiffs' equity was worthless when the Recapitalization was approved, and that the Recapitalization was effected at a fair price, Op. 130, Plaintiffs' unjust enrichment claim is without merit. As Plaintiffs acknowledge, an element of unjust enrichment is that they must have suffered an "impoverishment," *i.e.*, they were "deprived of the benefit unjustifiably conferred upon the defendant[s]." OB 22; *see also Nemec v. Shrader*, 991 A.2d 1120, 1130 (Del. 2010) (reciting "an impoverishment" as an element of unjust enrichment). Given the court's finding that "Plaintiffs necessarily 'received the substantial equivalent in value of what they had before'" the Recapitalization, Op. 115-16, Plaintiffs suffered no impoverishment. Hence, Plaintiffs provide no basis for reversing the Trial Court's exercise of discretion not to award disgorgement or rescissionary damages.

II. THE TRIAL COURT'S VALUATION FINDINGS ARE SUPPORTED BY THE RECORD.

A. Question Presented

Were the Trial Court's fact findings as to the value of Plaintiffs' equity when the Recapitalization was approved clearly wrong? B224-31; B237-89.

B. Standard and Scope of Review

While framing their attack on the Trial Court's decision not to award damages as a legal question, Plaintiffs really challenge the court's fact findings as to the value of Plaintiffs' equity when the Recapitalization was approved. *See* OB 23-39. The parties agree that the court's fact findings may be overturned only if "clearly wrong and justice so requires." *Id*. at 23. "When factual findings are based on determinations regarding the credibility of witnesses. . . the deference already required by the clearly erroneous standard of appellate review is enhanced." *Cede & Co. v. Technicolor, Inc.*, 758 A.2d 485, 491 (Del. 2000).

C. Merits of Argument

1. The Trial Court Properly Allocated the Burden of Proof.

Plaintiffs argue that the Trial Court "relieved" Defendants of the burden to prove fair price and shifted the burden to Plaintiffs. OB 23, 26. That is plainly incorrect: the court found that "[t]he burden to establish the entire fairness of the Recapitalization is on the Defendants," and ultimately concluded that Defendants "have not carried their burden of proof." Op. 86, 120. Similarly, the court

imposed on Defendants the burden to prove that SMC's projections were unreliable, and found Defendants did so "[t]hrough Hausman's persuasive testimony." *Id*. at 104.

In any event, the impact of allocating the burden of proof is questionable. *See Ams. Min.*, 51 A.3d at 1242 ("shifting the burden. . . under a preponderance standard is not a major move, if one assumes. . . that the outcome of very few cases hinges on what happens if. . . the evidence is in equipoise."). As the tens of pages that the Trial Court devoted to its valuation analysis show, the valuation evidence here was far from a state of equipoise. Thus, the issue of which party had the burden was immaterial to the court's conclusion that the price was "more than fair."

Plaintiffs' real contention is that the unfairness of the process shows that the price was unfair as a matter of law. OB 24-25. The argument is without merit. While this Court has observed that process is "intertwined with price" such that a fair price does not necessarily "save the result," *Kahn v. Tremont Corp.*, 694 A.2d 422, 432 (Del. 1997), it has never gone so far as to hold, as Plaintiffs now suggest, that once the process exceeds some threshold of unfairness the price becomes *per se* unfair. Indeed, in *Tremont*, this Court remanded for "the requisite factual determinations under the appropriate standards, which underlie the concept of entire fairness." *Id.* at 433; *see also Trados*, 73 A.3d at 78 ("the fact that the

directors did not follow a fair process does not constitute a separate breach of duty"; "defendants' failure to deploy a procedural device such as a special committee resulted in their being forced to prove at trial that the Merger was entirely fair").

Contrary to Plaintiffs' suggestion that it ran afoul of *Tremont*, the Trial Court faithfully followed it. The court cited *Tremont* when it: (i) noted that "process can infect price"; (ii) found that "the fair price inquiry presented at trial was severely hampered by the unfairness of the process"; and (iii) ultimately concluded that the "grossly unfair process [did] render an otherwise fair price, even when a company's common stock ha[d] no value, not entirely fair"—before exercising its discretion to find that the unfairness of the process here might "justify shifting certain of the plaintiffs' attorneys' fees and costs to the defendants." Op. 117-19, 131. Plaintiffs were entitled to no more than that.

2. The Trial Court's Finding that the Recapitalization Price Was Fair Because SMC's Equity Was Worthless Is Supported by the Record.

Plaintiffs also contend that they were entitled to a fair price finding in their favor because Defendants' failure to rely on a DCF analysis or multiple valuation methodologies constituted, in their view, a "complete failure of proof." OB 25-26. They deride Hausman's valuation methodology as "litigation-driven" and "backward looking," and assert that Defendants' actions in 2002 belie his analysis.

Id. at 4, 6, 23, 26, 34-35. Plaintiffs' disagreement with the Trial Court's determination, after weighing each expert's credibility and opinions, to accept Hausman's methodology and to reject Reilly's provides no grounds for reversal.

This Court gives the Court of Chancery wide latitude to "rely upon its expertise and upon whatever evidence is presented" in resolving valuation matters. *Montgomery Cellular Holding, Inc. v. Dobler*, 880 A.2d 206, 222 (Del. 2005). The Trial Court was not required to accept either expert's methodologies, but "was free to use whatever methodology was supportable by the record to reach a valuation result," and "[t]he [c]ourt's chosen method. . . is entitled to deference from this Court." *Id.*; *see Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1179 (Del. 1995) ("this Court accords 'a high level of deference' to Court of Chancery findings based on the evaluation of expert financial testimony.").

Here, the Trial Court's review of the experts' methodologies and credibility led it to conclude that "the only credible valuations available" were offered by Hausman. *See supra* Facts, Section E.2.a. It found "none" of the so-called "contemporaneous valuations" relied on by Plaintiffs to be "credible." *See id*. Since each of Reilly's valuation methodologies was "based on. . . unreliable projections," each of his analyses were likewise unreliable. *See id.*; Op. 109-15. Because it entirely credited Hausman's testimony, the court found that SMC's pre-Recapitalization equity was worth $0. *See id*. Plaintiffs' attempt to re-litigate the

court's factual findings and credibility determinations is unavailing.

a. The Trial Court Correctly Valued SMC on a Standalone Basis Prior to the Recapitalization

Relying on *Kessler* and *ONTI*, *see supra* at 19, Plaintiffs argue that the Trial Court erred by not including in its valuation of SMC any additional value provided by e-Media and NaviSite, which SMC acquired with the new money raised through the Recapitalization. OB 27-31. Plaintiffs' reliance on each case misses the mark, and, in any event, their argument is defeated by the court's findings of fact.

Kessler noted that "when the court determines that the company's business plan as of the merger included specific expansion plans or changes in strategy, those are corporate opportunities that must be considered part of the firm's value." 2006 WL 4764042, at *14 n.51. The court found that the value of the company's expansion plans had to be included in the company's value just prior to the squeeze-out merger at issue because the company was "on the verge of break-through growth, having gotten the hang of running the first few facilities, and [was] well-positioned to replicate its success at additional locations." *Id*. at *14.

ONTI held that it was appropriate to consider the subject company's value to a strategic partner when assessing the value of minority stockholders' shares, given that a planned merger of the surviving company was already "effectively in place" at the time of the squeeze-out merger. 751 A.2d at 909-11. The court likened the company's strategic merger plan to a plan to develop a Manhattan cornfield into an

office center, finding that minority shareholders would be "entitled to a valuation that reflects the value of a company that owns a cornfield that can be developed into a major office center." *Id*.

Neither decision is apropos. Far from being on the "verge of break-through growth" as in *Kessler*, or having a plan to capitalize on existing but as yet unrealized valuable assets as in *ONTI*, at the time of the Recapitalization SMC was facing a "panic," and "quickly running out of money." Op. 18. Unlike both *Kessler* and *ONTI*, SMC "did not have the capital needed to fund either of the e-Media or NaviSite. . . acquisitions, let alone both of them." *Id*. at 100. Rather, it was entirely "the 'new money,' not the 'old money,' [that] financed those acquisitions." *Id.* at 101.

To include in valuing the old money's equity at the time the Recapitalization was approved the expected value of acquisitions that could be financed only with the new money begs the fundamental question at the heart of the fair price analysis: what each of the old money and new money contributed to the recapitalized SMC. Plaintiffs have not answered that question; Reilly never opined on the value of SMC without the acquisitions. As the court found, the old money contributed nothing.

In any event, the Trial Court found that the price at which the Recapitalization was effected would still be fair even if, as Plaintiffs urge, the e-

Media and NaviSite acquisitions were included in the valuation of SMC when the Recapitalization was approved. After noting that Plaintiffs "did not contest [Defendants'] post-January value of the Company," and thus "waived this issue," the court nevertheless found that, if it were to consider the "relevant evidence," it would "credit Hausman's testimony that. . . the Company's equity still had no value in May and August 2002," after the acquisitions closed. Op. 116. The court agreed with Hausman that "the value that those acquisitions added to the Company was no greater than the purchase price: $1.6 million each." *Id.* at n.389. The court also agreed that, after "subtract[ing] the additional debt obligations incurred by the Company to fund those acquisitions," the "range of implied enterprise values. . . , just as it had been in January 2002, was negative." *Id.* These findings dispose of any contention that the court erred by not including the value of e-Media and NaviSite in its valuation of SMC.

b. The Record Supports the Trial Court's Rejection of Management Projections as Unreliable.

Plaintiffs also argue that the Trial Court erred because "a court may not ignore management's estimates, regardless of whether it trusts those numbers," unless either (i) the projections reflect a "deliberate attempt" by management to "falsify [the] projected revenues and expenses," or (ii) the projections were created "outside the company's ordinary course of business." OB 32 (quotations omitted). Plaintiffs misstate the applicable law.

While it is true that the Court of Chancery has consistently expressed "'a preference for the most recently prepared management projections available," *id.*; Op. 105 n.358, Plaintiffs' attempt to elevate that preference into a rule misses the mark. In exercising its broad discretion, the court has recognized that "methods of valuation, including a discounted cash flow analysis, are only as good as the inputs to the model." *Doft & Co. v. Travelocity.com, Inc.*, 2004 WL 1152338, at *10 (Del. Ch. May 21, 2004). Thus, where the proponent of the projections has "failed to prove that. . . reliance on the[] projections was justified," the court has rejected such projections and any valuation methodologies based thereon. *Id.* at **5-6 (finding management projections unreliable where "management held the strong view that these projections should not be relied upon because the industry was so new and volatile"); *see*, *e.g.*, *LongPath Cap., LLC v. Ramtron Int'l Corp.*, 2015 WL 4540443, at *10 (Del. Ch. June 30, 2015) (noting that "management projections can be, and have been, rejected entirely when they lack sufficient indicia of reliability" and declining to conduct a DCF analysis because the projections were unreliable); *Huff Fund Inv. P'ship v. CKx, Inc.*, 2013 WL 5878807, at *10 (Del. Ch. Nov. 1, 2013) (rejecting a DCF analysis based on "uncertain and therefore unreliable financial projections"), *aff'd*, -- A.3d --, 2015 WL 631586 (Del. Feb. 12, 2015).

Here, the Trial Court held that Defendants proved SMC's projections were

unreliable. Op. 104-07. Among other things, the court found that "the Company's management—even after Williams took over as CEO. . . in mid-2001—grossly overestimated the Company's revenues, even two to three months away." Op. 106. As for the January 2002 projections on which Plaintiffs rely, the court found that it "cannot accept that the same people who missed projections three-months out in September 2001 by a factor of three. . . would have been able to produce reliable projections in January 2002 for an entire year." *Id.* at 106-07.

Plaintiffs' contrary assertions do not undermine the Trial Court's valuation conclusions. Plaintiffs contend that Defendants' decision to "put additional money into SMC, . . . only makes sense based on the projections. . . and makes absolutely *no* sense under the negative valuation advanced by the Defendants." OB 34. The court's fact findings were to the contrary: it found that Wren and Javva invested in the Recapitalization not out of an optimistic view of SMC's prospects, but from the mistaken view (the "sunk cost fallacy") that they needed to invest to salvage their prior capital infusions. *See supra* at 9. Meanwhile, Catalyst, arguably the most sophisticated of SMC's stockholders, decided not to "throw 'good money after bad'" and *declined* to invest. *Id.*

Plaintiffs also point to "industry growth rates" at the time of the Recapitalization's approval as evidence of the projections' reliability. OB 34. The evidence purported to show that substantially larger and better funded companies

in the streaming industry grew their revenues from 1999 to 2002 at a rate "consistently higher" than the rate management was projecting for SMC (then in a "panic" and "quickly running out of money") to grow its revenues in 2002. OB 35. The court rejected that evidence. Op. 106. Rather than a "departure from the general preference of Delaware courts for fair price analyses to feature multiple. . . valuation methodologies. . . derived from contemporaneous management projections," the court found that "[t]his case just happens to be the exception." Op. 107 n.364. Plaintiffs provide no grounds for reversing that finding.

* * *

In short, the Trial Court fulfilled its responsibility. It evaluated *all* of the evidence placed before it, including the so-called contemporaneous valuations, weighed the credibility and methodologies of both sides' experts, and determined, in the final analysis, that at the time the Recapitalization was approved, SMC's equity was worth between negative $4.33 and negative $1.75 million—millions of dollars below the "more than fair" price of $4 million used in the Recapitalization. That Plaintiffs point to cases in which unfairness of the process may have infected the price, and cases that express preferences for multiple valuation methodologies, does not alter the fact that the court's findings are supported by the record.

III. THE TRIAL COURT'S FINDING THAT PLAINTIFFS DID NOT PROVE ANY DISTINCT DAMAGES ON THEIR DISCLOSURE CLAIM IS SUPPORTED BY THE RECORD.

A. Question Presented

Was the Trial Court's finding that Plaintiffs failed to prove any damages on their disclosure claim supported by the record, and did the court abuse its discretion in not awarding any remedy? B188-90; B309-10.

B. Standard and Scope of Review

Plaintiffs contend that the Trial Court erred by "dismissing" their disclosure claim. OB 40. But the claim was not dismissed. Rather, the court found that "Plaintiffs [did] not demonstrate[] that the Fall 2002 Update harmed them separate from the overall Recapitalization," and thus considered the disclosure claim "in the context of [its] entire fairness analysis." Op. 93 n.325. The court's fact findings may be overturned only if "clearly wrong and justice so requires," and its decision whether to award a particular remedy is reviewed for abuse of discretion. *See supra* Section I.B.

C. Merits of Argument

Plaintiffs argue that damages are warranted under a "virtual *per se* rule of awarding damages for breach of the fiduciary duty of disclosure." OB 42 (citing *Cinerama*, 663 A.2d at 1163 (quoting *Tri-Star*, 634 A.2d at 333)). This Court, however, rejected any interpretation of *Tri-Star* as giving rise to a *per se* rule of damages. *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 146-47 (Del.

1997) (confining "the dictum in *Tri-Star*. . . to the facts of that case" and holding that "there is no *per se* rule that would allow damages for all director breaches of the fiduciary duty of disclosure"). Rather, "[d]amages will be available only in circumstances where disclosure violations are concomitant with deprivation to stockholders' economic interests or impairment of their voting rights." *Id.* at 147; *see also In re J.P. Morgan Chase & Co. S'holder Litig*., 906 A.2d 766, 774 (Del. 2006). No deprivation of economic rights occurred here. And since no obligation existed to disclose the Recapitalization until *after* the stockholder action by written consent, *see* 8 *Del. C.* § 228(e), the Fall 2002 Update had no impact on Plaintiffs' voting rights (nor do Plaintiffs cite any). Plaintiffs' argument is nothing more than an attempt to re-litigate the court's fact findings.

Plaintiffs argue that they did prove harm distinct from any harm suffered in the Recapitalization, namely "the violation of their preemptive rights and the delay and prejudice to their litigation rights." OB 44. That argument has no merit. Plaintiffs neither pled nor proved violations of any contractual preemptive rights. To the contrary, the court found that "Defendants were under no duty to allow the Plaintiffs to participate" in the transaction. Op. 129-30. Absent any economic harm or damages separately attributable to their disclosure claim, Plaintiffs' claim of prejudice to their litigation rights cannot be sustained. The court's decision not to award any relief on that claim was not an abuse of discretion.

IV. THE TRIAL COURT CORRECTLY HELD THAT THE PREFERRED A PLAINTIFFS LACKED STANDING.

A. Question Presented

Did the Trial Court correctly conclude, as a matter of law, that the Preferred A Plaintiffs lacked standing to challenge actions by the Board before they became stockholders? B119-22.

B. Standard and Scope of Review

The parties agree that the Court of Chancery's grant of summary judgment is reviewed *de novo*. OB 45.

C. Merits of Argument

The Trial Court dismissed the Preferred A Plaintiffs' claims on summary judgment for lack of standing because they were not SMC stockholders at the time the Recapitalization was developed, approved or implemented. SJ Op. 19-22. That ruling was correct.

In *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171, 1177-78 (Del. 1988), this Court held that a corporate parent and the directors of a wholly-owned subsidiary owed no fiduciary duties to prospective stockholders of the subsidiary after the parent declared its intention to spin-off the subsidiary. In doing so, this Court rejected the notion that a fiduciary relationship existed between a corporation's board and prospective stockholders before the shares were actually issued. It held instead that "the duty of loyalty arises only upon

establishment of the underlying relationship," and that the expectation of becoming a stockholder does not create an equitable interest sufficient for fiduciary duties to attach. *Id.* at 1172, 1175-78.

This Court's ruling in *Anadarko* is echoed in subsequent cases holding that the holder of an instrument convertible into stock does not become a stockholder owed fiduciary duties until after the conversion has actually taken place. *See*, *e.g.*, *Aspen Advisors LLC v. United Artists Theatre Co.*, 861 A.2d 1251, 1263 (Del. 2004) ("the 'convertibility feature' of warrants does not impart stockholder status unless and until the warrant is converted"); *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988) (holding a convertible debenture holder has no equitable interest in a corporation until the debenture "is converted"). Here, in holding that "[a]greeing to purchase stock does not make one a stockholder, especially if the stock will not even be issued until the consummation of the challenged series of actions" the Trial Court adhered to *Anadarko, United Artists* and *Simons*. SJ Op. 20.

Consequently, the Preferred A Plaintiffs' argument that their senior debt was converted into equity "when they executed the Subscription and Surrender Agreements," OB 45, is wrong as a matter of law. It is also belied by the plain and unambiguous terms of those agreements. In those agreements, the Preferred A Plaintiffs agreed that their rights as creditors would terminate simultaneously with their receipt of preferred stock at a closing that was to take place in the future.

A254 §4. Thus, their mere execution of the agreements did not change their status. Nor could it have since the Subscription Agreements were not delivered to SMC until July 31, 2002, and the Preferred A shares were not created until SMC's charter was amended on August 9, 2002. B9; Op. 41. Hence, the Preferred A Plaintiffs did not surrender their contractual rights or acquire an equitable interest, and were not owed fiduciary duties, until after that date.

In any event, if this Court affirms the Opinion's holding that Plaintiffs are not entitled to any disgorgement, rescissionary or monetary damages as a result of the Recapitalization (as we respectfully submit it should), then the standing of the Preferred A Plaintiffs to challenge the Recapitalization will be academic.

V. THE TRIAL COURT ABUSED ITS DISCRETION BY AWARDING PLAINTIFFS' COUNSEL $2 MILLION IN FEES AND EXPENSES.

A. Question Presented

Did the Trial Court abuse its discretion in calculating the award of attorneys' fees and expenses to Plaintiffs' counsel? B336-76.

B. Standard and Scope of Review

The parties agree that the standard of review for the calculation of an attorneys' fee award is abuse of discretion. OB 48.

C. Merits of Argument

The parties agree that the Trial Court abused its discretion by applying its novel "quasi-*Sugarland* analysis." OB 48. Plaintiffs contend that, as a matter of *quantum meruit*, the court should have awarded them the entire $11,427,195.23 in fees and expenses their lead counsel recorded, but which Plaintiffs do not owe and have not paid due to their contingency fee arrangement. *Id*. at 48-49. Defendants' cross-appeal (*infra* Section VII) argues that, because Plaintiffs did not incur any legal fees or expenses or generate a valuable benefit, there was no basis for fee shifting or a fee award. Addressing only Plaintiffs' contentions here, a *quantum meruit* award of over $11.4 million to contingency counsel who recovered no benefit would run afoul of both Delaware law and public policy.

Neither the Trial Court nor any party has cited any case in which a Delaware court has relied upon *quantum meruit* to "shift" fees not actually incurred under the

pre-litigation bad faith exception to the American Rule, the sole exception invoked by the Trial Court in exercising its discretion to award fees. *See* Fee Op. 6. Rather, a *quantum meruit* fee award may be appropriate under the corporate benefit doctrine if the litigation confers a "non-monetary valuable benefit upon [a] corporate enterprise or its s[tock]holders." *Dover Historical Soc'y Inc. v. City of Dover Planning Comm'n*, 902 A.2d 1084, 1090 (Del. 2006) (parenthesis omitted). In such cases, the fee award is to be calculated relative to the value of the benefit that the litigation conferred. *See In re First Interstate Bancorp Consol. S'holder Litig.,* 756 A.2d 353, 363 (Del. Ch. 1999), *aff'd* 755 A.2d 388 (Del. 2000).

None of the elements of the corporate benefit doctrine are satisfied here. While implying that the litigation produced a benefit, OB 49, Plaintiffs cannot articulate what that benefit was or state how it was valuable. For its part, the only benefit the Trial Court identified was that Plaintiffs "vindicated certain important rights," but observed that the value of that result was $0. Fee Op. 10.

In fact, this litigation did not result in any valuable benefit to anyone. It did not result in a money judgment. Nor did it produce, either for the benefit of Plaintiffs or any non-party, corrective disclosures, modification to an impending transaction or anything else that Delaware courts have recognized as a valuable non-monetary benefit that could support a *quantum meruit* fee award. *See In re Sauer-Danfoss Inc. S'holders Litig.*, 65 A.3d 1116, 1141 & n.9 (Del. Ch. 2011)

(collecting examples of "meaningful" therapeutic relief). As such, the only appropriate fee award is $0. *See*, *e.g.*, *Crothall v. Zimmerman*, 94 A.3d 733, 737 (Del. 2014) (holding that no fee could be awarded based on a vacated judgment that did not create a corporate benefit); *Ryan v. Tad's Enters., Inc.*, 709 A.2d 682, 706 & n.29 (Del. Ch. 1996), *aff'd* 693 A.2d 1082 (Del. 1997) (holding that fees could not be awarded because the litigation did not benefit anyone other than the plaintiffs). If mere vindication of rights, absent any valuable benefit, were sufficient for an attorneys' fees award, then *quantum meruit* and the corporate benefit doctrine would cease to have any meaning.

Moreover, an award of attorneys' fees and expenses in this case would set bad public policy. Delaware law seeks to align the interests of counsel and client by tying the amount of a fee award to the benefit conferred. *See Sauer-Danfoss*, 65 A.3d at 1140-41. Under these circumstances, awarding Plaintiffs' counsel its full $11.4 million in fees and expenses, even though counsel recovered nothing for its clients and agreed not to be paid unless its clients were paid, would *misalign* the interests of counsel and its clients.

For the foregoing reasons, Plaintiffs' ascriptions of error to the Trial Court in connection with the Opinion, the SJ Opinion and the Fee Opinion are meritless.

ARGUMENTS ON CROSS APPEAL

VI. THE TRIAL COURT ERRED BY NOT DISMISSING PLAINTIFFS' CLAIMS AS SOLELY DERIVATIVE.

A. Question Presented

Did the Trial Court err by not dismissing Plaintiffs' claims as derivative in nature pursuant to the continuous ownership rule? B44-53; B108-19; B255-67.

B. Standard and Scope of Review

Questions of law are reviewed *de novo*. *Feldman v. Cutaia*, 951 A.2d 727, 730 (Del. 2008) (*Feldman II*), *aff'g* 956 A.2d 644 (Del. Ch. 2007) (*Feldman I*).

C. Merits of Argument

Because SMC was merged out of existence in 2006, Plaintiffs have standing to assert only direct claims challenging the Recapitalization. The Trial Court held Plaintiffs' claims to be direct "expropriation" claims under *Gentile*. Alternatively, the court found those claims are direct under *Carsanaro*. The Trial Court erred in its application of the law with respect to both holdings.

1. The Plaintiffs' Claims Are Not Direct Under *Gentile*.

Ordinarily, claims of unfair equity dilution are derivative because the crux of such a claim—the corporation issued shares for inadequate consideration—is an injury to the corporation that falls on all stockholders equally. *Gentile*, 906 A.2d at 99; *Feldman I*, 956 A.2d at 655-56; *see Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004) (establishing the standard to determine if a

claim is derivative or direct). However, in *Gentile*, this Court described "a species of corporate overpayment claim" that is "both derivative and direct in character," which arises when:

> (1) a stockholder having majority or effective control causes the corporation to issue 'excessive' shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling stockholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders.

906 A.2d at 100. As this Court explained, in cases involving the "overpayment (or 'over-issuance') of shares to the controlling stockholder, . . . the corporation is harmed," meaning the claim is derivative. *Id.* Yet, at the same time, the "improper transfer—or expropriation—of economic value and voting power from the public shareholders to the majority or controlling stockholder" also results in "the public shareholders [being] harmed, uniquely and individually, to the same extent that the controlling shareholder is (correspondingly) benefitted," rendering the claim simultaneously direct. *Id.*; *accord Feldman I*, 956 A.2d at 657.

Thus, what distinguishes a *Gentile* claim from an ordinary, derivative claim for dilution is a breach of duty by the controlling stockholder that expands its equity interest *directly at the expense of the minority*. *Gentile*, 906 A.2d at 100, 102. In *Gentile*, the minority stockholders' claim was unique, and thus direct under *Tooley*, precisely because the minority stockholders were harmed in direct

proportion to the controlling stockholder's expropriation. *Id.* at 101 (discussing *Tri-Star*, 634 A.2d at 332-33).

The *Gentile* exception was intended to be narrow so as not swallow the general rule that equity dilution claims are solely derivative. *See Gentile*, 906 A.2d at 99 & n.18 (citing *Kramer* and similar cases). Any other reading threatens to undermine the continuous ownership rule, which is a "bedrock tenet" of Delaware corporate law. *See In re New Valley Corp. Deriv. Litig.*, 2004 WL 1700530, at *3 (Del. Ch. June 28, 2004).

a. There Was No Corresponding Dilution.

While acknowledging that the "Recapitalization did not increase Wren and Javva's ownership of [SMC] 'to the same extent' that it diluted Plaintiffs' equity," the Trial Court held, without explanation, that fact "does not change the Court's conclusion that the Recapitalization may have given rise to direct and derivative harm." *Id.* at 59. By doing so, the court read the second criterion out of *Gentile*.

The stock issued at a fair price as part of the Recapitalization did not benefit Defendants exclusively. The issuances instead caused varying degrees of accretion and dilution both to Plaintiffs and Defendants: (i) the Preferred A shares issued to Wren, Javva, Catalyst and several Plaintiffs diluted the other Plaintiffs' equity interests in SMC; (ii) the Preferred B-2 shares issued to e-Media's parent diluted all of SMC's stockholders, including Wren, Javva and Catalyst; and (iii) the

Preferred B-1 shares issued to Wren and Javva diluted all of the other stockholders, including Plaintiffs and Catalyst. Catalyst received no B-1 shares, and as a result saw its total equity diluted from approximately 21% to 9%, the exact same dilution suffered by those Plaintiffs who held both Preferred A and common stock.

Because the dilution caused by the issuance of new shares in the Recapitalization did not fall uniquely on Plaintiffs, and those issuances did not transfer economic and voting rights solely and proportionately to Defendants, Plaintiffs' claims are not direct under *Gentile* as a matter of law. *See Feldman I*, 956 A.2d at 658 (holding complaint did not state a *Gentile* claim because it did not allege defendants "exclusively benefitted" from the transaction at issue); *In re Paxson Commc'n Corp. S'holders Litig.*, 2001 WL 812028, at *5 (Del. Ch. July 12, 2001) ("Together, *Tri-Star* and [*Oliver v. Boston Univ.*, 2000 WL 1091480 (Del. Ch. July 25, 2000)] stand for the proposition that dilution claims are individual in nature where a significant stockholder's interest is increased 'at the sole expense of the minority.'"); *St. Clair Shores Gen. Employees Ret. Sys. v. Eibeler*, 745 F.Supp.2d 303, 313 n.10 (S.D.N.Y. 2010) (holding complaint did not state a *Gentile* claim because it did not allege "Defendants were the *sole* beneficiary of the options grants"). The court's contrary holding was error.

b. There Was No Control Group Expropriation.

Additionally and independently, the Trial Court erred by holding that

Gentile's "controlling stockholder" criterion was satisfied because Wren, Javva and Catalyst comprised a control group. When entities that collectively possess majority voting power are controlled by the same person, the law recognizes those entities (despite their legal separateness) as a control group—the functional equivalent of a single controlling stockholder—because they will vote as one. Likewise, separate stockholders whose total equity constitutes a majority of the corporation's stock, and that have agreed to vote as one, qualify as a control group. *See*, *e.g.*, *Tri-Star*, 634 A.2d at 322, 329 (holding that Coca-Cola was a controlling stockholder by virtue of agreements requiring it and the holders of over 56% of the company's stock to vote together); *Williamson v. Cox Commc'ns, Inc.*, 2006 WL 1586375, at *2, *5 n.52 (Del. Ch. June 5, 2006) (finding allegations that Comcast and Cox were controlling stockholders stated a claim where they had "entered into a series of agreements" designed to transfer "complete control" of the company's voting power to AT&T so that the three of them could "carve-up" the company's assets); *see also In re PNB Hldg. Co. S'holders Litig.*, 2006 WL 2403999, at *10 (Del. Ch. Aug. 18, 2006) (describing the agreement needed to form a control group as a "blood pact to act together").

Thus, a control group exists when its members forfeit their individual interests to place their voting power under common control. In contrast, parallel interests, concerted action, or contractual—even blood—relations among separate

stockholders will not alone give rise to a control group. *Williamson*, 2006 WL 1586375, at *6; *PNB*, 2006 WL 2403999, at **9-10. Otherwise, a control group—and a direct claim—would exist any time that multiple stockholders agree to vote together to carry out corporate action. *See Kennedy v. Venrock Assocs.*, 348 F.3d 584, 591 (7th Cir. 2003).

Here, the court found a control group to exist based on three unrelated minority stockholders having acted together to approve the Recapitalization. Rather than establish that a control group existed, however, the Trial Court's finding that Catalyst agreed to approve the Recapitalization in exchange for a 90-day "right to invest" in the Recapitalization demonstrates the opposite. If Catalyst had to be induced to support the Recapitalization with a *quid pro quo*, then Wren, Javva and Catalyst necessarily were not acting as a single entity; they necessarily did not have a "blood pact" to act together; Catalyst necessarily did not have any "lack of autonomy" from, or "devotion" to, Wren or Javva, such that the three of them comprised a single, monolithic entity; and necessarily there was no agreement in place that required those three to vote as one. *See PNB*, 2006 WL 2403999, at *10; *Tri-Star*, 634 A.2d at 322.

The court's finding that Catalyst needed a *quid pro quo* to vote for the Recapitalization compels the conclusion that Catalyst approved the Recapitalization to further its own interests as a stockholder, not the interests of a

group. Holding that separate stockholders making a decision based on their independent judgment constitutes the functional equivalent of a single controlling stockholder because they voted together would turn nearly every allegation of concerted action into a control group, and transform every challenge to stockholder action into a direct claim.

Further, the Trial Court erred in concluding that Plaintiffs' claims were direct under *Gentile* despite having found, by virtue of concluding that the Recapitalization price was fair, that Defendants did not cause an "excessive" issuance of stock, *i.e.*, the *sine qua non* of a *Gentile* claim. The finding means that the minority stockholders did not suffer any "expropriation" at the hands of a controller, and, thus, as a matter of law, their claims are not direct.

Because Plaintiffs' claims for breach of fiduciary duty are solely derivative, so too are their claims for aiding and abetting and unjust enrichment, which are premised on the same facts. *See Feldman I*, 956 A.2d at 662 & n.66. Furthermore, the court erred in holding that the disclosure claims are direct, Motion to Dismiss Mem. Op. dated Oct. 28, 2011 (attached) at 27 n.48, because (as discussed above) those claims do not implicate any separate deprivation of stockholders' voting rights or economic interests. *See J.P. Morgan*, 906 A.2d at 772. For these reasons, the court's holding that Plaintiffs had standing to pursue direct claims under *Gentile* was error.

2. The Trial Court Erred in Applying *Carsanaro*.

As an alternative, the Trial Court held that even if Plaintiffs' claims were not direct under *Gentile*, they were direct under *Carsanaro* because "a majority of the Board was conflicted. . . when it approved and implemented the Recapitalization." Op. 73. The court's application of *Carsanaro* was error.

Just because a majority of the Board was conflicted when it approved the transaction does not create a direct claim. In *Tooley*, this Court held that to establish a direct claim, "[t]he stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation." 845 A.2d at 1039. Any injury suffered by minority stockholders from an over-issuance of shares approved by a majority of conflicted directors is the exact same injury suffered by the corporation from the over-issuance. *See Feldman II*, 951 A.2d at 733 (citing *Gentile*, 906 A.2d at 99) ("Where all of a corporation's stockholders are harmed and would recover *pro rata* in proportion with their ownership of the corporation's stock solely because they are stockholders, then the claim is derivative in nature."); *Tooley*, 845 A.2d at 1039 ("The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation.").

By expanding direct claims to any over-issuance of shares approved by a

conflicted majority of directors *Carsanaro* (and this case) eliminated the requirement that the over-issuance "uniquely and individually" harm the minority stockholders, the essential litmus test for a direct claim under *Tooley*. In contrast to *Gentile*, in the *Carsanaro* paradigm, the public stockholders are *not* harmed, uniquely and individually, to the same extent that the controlling stockholder is (correspondingly) benefitted, because the controlling stockholder does not enter the equation. As such, *Carsanaro* does not describe a breach of duty owed directly to a stockholder, or an injury suffered directly by a stockholder distinct from any injury suffered by the corporation itself. Nothing materially distinguishes a claim under *Carsanaro* from a typical claim of self-dealing by an interested board, which claims this Court has repeatedly reaffirmed are solely derivative even in the context of dilution.

Indeed, under *Carsanaro*, the only dilution claims that would not qualify as direct would be those rare claims where a disinterested and independent board majority approved an allegedly unfair stock issuance. Such an expanded definition of a direct claim would swallow up the continuous ownership rule—a result inconsistent with *Gentile,* the cases on which it is based, and its progeny. *See Gentile*, 906 A.2d at 99-102 & n.20 (citing *Turner v. Bernstein*, 1999 WL 66532, at *11 (Del. Ch. Feb. 9, 1999); *Paxson*, 2001 WL 812028, at *5, and stating that dilution claims remain ordinarily solely derivative in nature); *Gatz v. Ponsoldt*, 925

A.2d 1265, 1274 (Del. 2007); *Feldman I*, 956 A.2d at 657; *DiRienzio v. Lichtenstein*, 2013 WL 5503034, *25 (Del. Ch. Sept. 30, 2013).

The Trial Court relied on this Court's citation in *Gentile* to *Avacus P'rs, L.P. v. Brian*, 1990 WL 161909, at *6 (Del. Ch. Oct. 24, 1990), as support for *Carsanaro*'s expanded interpretation of a direct claim under *Gentile*. Op. 72 & n.264. In *Gentile*, the Court cited *Avacus* for the proposition that dilution claims are "exclusively derivative." *Gentile*, 906 A.2d at 99 & n.18. In *Avacus*, however, the Court of Chancery observed that a dilution claim could be direct or derivative depending on the context; if the board issues shares for inadequate consideration, the claim is derivative, but if the board issues shares for the purpose of entrenchment, the claim would be direct because the harm is dilution of voting rights. *Avacus*, 1990 WL 161909, at *6. Thus, *Avacus* undermines, rather than supports, the expansive reading of *Gentile* that the Court of Chancery purported to find in *Carsanaro*.

In sum, on the facts the court found, Plaintiffs' claims are purely derivative and should have been dismissed.

VII. THE TRIAL COURT ERRED IN AWARDING ATTORNEYS' FEES AND EXPENSES.

A. Question Presented

Did the Trial Court abuse its discretion in awarding attorneys' fees and expenses under the pre-litigation bad faith exception to the American Rule, even though Plaintiffs, due to the completely contingent nature of their fee arrangement with counsel, incurred no such fees or expenses? B336-76.

B. Standard and Scope of Review

The Trial Court's application of legal precepts underlying an award of attorneys' fees is reviewed *de novo*. *Dover Historical*, 902 A.2d at 1089. The court's ruling on a fee application is reviewed for abuse of discretion. *Id*.

C. Merits of Argument

The disclosure in the fee petition that Plaintiffs had not actually incurred any legal fees or expenses should have ended the Trial Court's consideration of whether this case might "qualify for similar treatment" as in *Saliba* and resulted in denial of Plaintiffs' petition for fees and expenses. Instead, the court jettisoned *Saliba* and crafted its "quasi-*Sugarland*" exception to the American Rule. In so doing, the Trial Court contravened Delaware law and abused its discretion.

1. Applying the Bad Faith Pre-Litigation Conduct Exception Should Have Led the Trial Court to Deny the Fee Petition.

"Generally, under what is commonly known as the American Rule, 'absent express statutory provisions to the contrary, each party involved in litigation will

bear only their individual attorneys' fees no matter what the outcome of the litigation.'" *Saliba II*, 13 A.3d at 758. Among the few recognized exceptions are "cases in which, although a defendant did not misuse the 'litigation process in any way, . . . the action giving rise to the suit involved bad faith, fraud,' conduct that was totally unjustified or the 'like,'" where "attorneys' fees are considered an appropriate part of damages." *Scion Breckenridge Managing Member LLC v. ASB Allegiance Real Estate Fund*, 68 A.3d 665, 687 (Del. 2013) (*Scion I*) (ellipsis in original), *on remand*, 2013 WL 5152295 (Del. Ch. Sept. 16, 2013) (*Scion II*).

Thus, Delaware law holds that when the requisite bad faith is present, a court may shift fees and expenses to the extent they were actually and reasonably incurred. *Scion II*, 2013 WL 5152295, at *8. If plaintiffs have *not* incurred any such fees and expenses, however, it follows that they have not been damaged by bringing the litigation, and therefore fee shifting is not needed to make them whole. *Id*. Put simply, for fees to be "shifted," there must be actual fees to shift.

Saliba stands for that very proposition. There, this Court held that the court's "decision to award attorneys' fees and costs was well within [its] discretion," because "[a]bsent this award, [plaintiffs] would have been penalized for bringing a successful claim against the [defendants] for breach of their fiduciary duty of loyalty," and concluded that, where plaintiffs were "left without a typical damage award," "it would be unfair and inequitable for [plaintiffs] to

shoulder the costs of litigation arising out of improper prelitigation conduct." 13 A.3d at 759.

The equitable considerations for fee shifting in *Saliba* are absent here. Plaintiffs did not "shoulder" any burden or suffer any penalty as a result of bringing this litigation. Rather, before suing, Plaintiffs contracted to shift any such burden to their counsel, which accepted the burden in return for 40% of any recovery. A676.

Scion illustrates the point. There, the court granted plaintiffs' ("ASB") claim to reform several agreements with the defendants ("Scion"). *Scion I*, 68 A.3d at 675. This Court reversed the Court of Chancery's award of attorneys' fees under contractual fee-shifting provisions because ASB had not "incurr[ed]" any such fees since ASB's attorneys had agreed to represent ASB for free. *Id*. at 683-84. This Court then remanded for consideration of whether fee shifting might still be appropriate on bad faith grounds. *Id.* at 687-88. The Court of Chancery denied ASB's application for fees based on the rationale of *Scion I*. Noting that it did not condone Scion's pre-litigation conduct, the court nevertheless concluded that, because ASB had incurred no attorneys' fees, it had suffered no damages and thus was not entitled to fee shifting on the basis of Scion's pre-litigation conduct. *Scion II*, 2013 WL 5152295, at **8-10.

The two rationales cited by the Trial Court for equitable fee shifting do not

support a different result. While the court said that "Defendants who rightfully ought to owe Plaintiffs' attorneys' fees should not be able to avoid their obligations," Fee Op. 6-7, the fee award to counsel neither compensates nor benefits Plaintiffs in any way. Awarding fees that have *no* compensatory component is effectively a punitive award, which Delaware law rejects. *See Cantor Fitzgerald, L.P. v. Cantor*, 2001 WL 536911, at *3 (Del. Ch. May 11, 2001) (cautioning against any measure of damages for breach of the duty of loyalty that could be "characterized as punitive."). In *Cantor* (which this Court cited in *Saliba*), the court confined its fee-shifting-as-damages to "attorneys' fees and expenses *spent* to address the defendants' conduct," concluding that to award any greater amount would be "tantamount to awarding punitive damages." *Id.* (emphasis added).

The other rationale the Trial Court cited—preventing contingency counsel's efforts from being a "charitable undertaking"—effectively transforms the pre-litigation bad faith exception under *Saliba* into a form of award to counsel rather than to Plaintiffs, even though *Saliba* speaks only to "the right of a *party* to recover attorneys' fees." Fee Op. 6, 9 (emphasis added). Neither *Saliba* nor any other pre-litigation bad faith exception case even suggests that fee shifting may be employed to compensate counsel rather than a party. Even if it were a basis to do so, Defendants' pre-litigation conduct did not harm—and thereby warrant any

compensation to—Plaintiffs' counsel, who was not engaged until years after the bad faith conduct at issue, and were not subjected to any bad faith during the litigation. *Id.* 6 n.21.

In any event, counsel's efforts would not be rendered charitable absent a fee award. Counsel has not been paid because that is the contractual bargain that they struck with Plaintiffs in exchange for a large potential premium in the event that they recovered a money judgment, and is the anticipated consequence of its failure to recover a money judgment. A fee award would provide a windfall to a sophisticated law firm that bargained to be paid only if it could recover money damages for its clients, and then failed to do so.

2. The Trial Court's Development of a New Quasi-*Sugarland* Exception to the American Rule Was Error.

Since there were no fees to shift as damages under *Saliba* and no basis to invoke either the common fund or corporate benefit doctrines, Fee Op. 4 n.12, the Trial Court posited a new "quasi-*Sugarland*" exception to the American Rule, whereby the court "project[s] a reasonable pre-litigation recovery range" and "discount[s] it based upon the ultimate failure to recover any damages." *Id.* at 9-10. Both parties agree that quasi-*Sugarland* should be rejected. *See* OB 48-49.

The new exception defies this Court's stated reluctance to "creat[e] and expand[] judge-made exceptions to the American Rule absent express and clear legislative guidance." *Dover Historical*, 902 A.2d at 1091. The Trial Court

identified no legislative basis for its new exception or any gap in Delaware law necessitating a new equitable rule.

Further, it is contrary to existing law relating to fee awards, the principal purpose of which is to encourage meritorious corporate litigation that confers value on third parties by compensating those who create the value. *See Goodrich v. E.F. Hutton Grp., Inc.*, 681 A.2d 1039, 1050 (Del. 1996). Delaware courts ordinarily grant fee awards based upon the value that the litigation conferred upon other stockholders or the corporation itself. Indeed, the most important factor when determining a fee award is the value of the benefit actually conferred by the litigation. *Ams. Min.*, 51 A.3d at 1254. Rather than reward meritorious litigation, quasi-*Sugarland* creates a paradox in which, if the plaintiff produces no benefit, then the court disregards the *actual value* resulting from the litigation (zero) and instead awards fees based on a *hypothetical value* that the case might have produced (but failed to).

The quasi-*Sugarland* exception also introduces new practical problems to the already difficult arena of calculating fee awards. The Fee Opinion provides no guidance as to what standard courts will use to determine either the hypothetical range of reasonable expected recovery or the appropriate discount for failing to achieve that range. The Fee Opinion should be reversed in its entirety.

CONCLUSION

For the foregoing reasons, Defendants respectfully request that this Court (i) hold that Plaintiffs lack standing because their claims are derivative and, accordingly, reverse the judgments against Defendants and the Fee Opinion; or (ii) in the alternative, affirm the Opinion in all respects and reverse the Fee Opinion.

Dated: August 28, 2015

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