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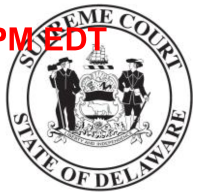

IN THE SUPREME COURT OF THE STATE OF DELAWARE

MORRIS FUCHS, *et al.*,

Plaintiffs-Below,
Appellants, Cross-Appellees

v.

WREN HOLDINGS, LLC, *et al.*,

Defendants-Below,
Appellees, Cross-Appellants.

No. 281, 2015

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

APPELLANTS' REPLY BRIEF ON APPEAL AND ANSWERING BRIEF ON CROSS-APPEAL

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INTRODUCTION

Plaintiffs demonstrated that the Chancery Court legally erred in two primary ways in providing an insufficient remedy for Defendants' egregious breaches of fiduciary duty. *First*, the court failed to appreciate that such severe breaches of the duty of loyalty deserve a remedy that prevents wrongdoers, such as Defendants here, from benefiting as a result of their misdeeds. The law and facts here compel an award, either under fiduciary duty or unjust enrichment law, of disgorgement and/or rescission sufficient to prevent Defendants from retaining their ill-gotten gains. The court found that Defendants also violated their fiduciary duties by failing to disclose the key details of the Transactions, and thereby prevented Plaintiffs from seeking rescission or other remedies at the time of this misconduct. Delaware law's remedies for these violations focus respectively on the benefits reaped by Defendants and the opportunities lost by Plaintiffs. Accordingly, they are independent of the actual value of SMC at the time of the violations.

Second, the court erred in its fair price analysis, by (a) effectively shifting the burdens of proof and uncertainty from the wrongdoers to the victims, Plaintiffs here, (b) excluding from its fair price analysis the value of the assets that were the entire focus and purpose of the Transactions, and (c) excluding several contemporaneous and ordinary-course management valuations and revenue projections. The court also legally erred in its determination of when fiduciary duties were owed to the Preferred A Plaintiffs and in substituting a novel, litigation-recovery-range analysis for the proper quantum meruit model of

determining attorneys' fees.

In response, Defendants primarily urge that the Chancery Court's determinations were fact findings and discretionary rulings to which this Court should defer. That is a mischaracterization: The errors that Plaintiffs raise are fundamental legal rulings about the standards applicable to Defendants' conduct and the contours of a legally sufficient remedy for their wrongdoing. Moreover, in all events, even under the abuse of discretion standard of review Defendants advocate, the Chancery Court's legal errors are reviewed de novo.

None of Defendants' attempts to rebut the Chancery Court's legal errors survives binding Delaware law or Defendants' own concessions. *First*, Defendants' argument that the court had discretion to deny all remedies for their proven breaches of fiduciary duty contradicts the very cases that Defendants cite, which confirm that disgorgement or rescissory damages are required here. Defendants' follow-on attempt to rewrite the court's factual findings only underscores the court's reversible legal errors in ignoring the harm from Defendants' expropriation of Plaintiffs' equity, disregarding Defendants' circumvention of Plaintiffs' preemptive rights, and shifting the burden of any uncertainty on damages away from the wrongdoers to the victims. Absent damages here, faithless fiduciaries would be given a blueprint for wrongdoing with impunity.

Second, Defendants do not dispute that the Chancery Court's factual findings demonstrate that they committed a disclosure violation. Rather, Defendants contend that the court properly denied damages on that claim because

Plaintiffs did not prove harm separate from the Transactions. But this argument merely repeats the court's legal error: There is *no* requirement that Plaintiffs prove separate harm. And in any event, Plaintiffs *did* prove such harm in the form of their lost opportunity to invest and the circumvention of their preemptive rights.

Third, Defendants again do not dispute the facts underlying the Chancery Court's legal errors in its fair price analysis: that the e-Media and NaviSite acquisitions were non-speculative, that those acquisitions drove the Transactions, and that the contemporaneous management valuations and projections offered at trial were made in the ordinary course of business by Defendants' hand-picked management team. Defendants thus echo the court's legal errors and contravention of Delaware law by arguing that the court properly denied damages based on a fair price analysis that excluded those acquisitions and projections.

Fourth, Plaintiffs seek recovery for harms they suffered individually from Defendants' wrongdoing. Defendants' arguments that Plaintiffs lack standing therefore ring hollow since, as the Chancery Court held, Plaintiffs have standing to assert their direct claims because Wren, Javva, and Catalyst formed a control group and a majority of SMC's directors were conflicted.

Finally, while attorneys' fees are not an adequate remedy, Defendants' attempt to escape quantum meruit liability for attorneys' fees incurred due to their misconduct ignores myriad Delaware cases upholding fee awards in contingent cases and their concession below that the litigation created a benefit. This Court should correct the Chancery Court's several legal errors.

SUMMARY OF ARGUMENTS ON CROSS-APPEAL

6. Denied. The Chancery Court correctly held that Plaintiffs had standing to bring direct claims. The Chancery Court correctly held that Plaintiffs' expropriation claims are direct where the control group received nearly all of the benefit from the dilutive Self-Dealing Transactions. The court's factual findings demonstrate that Defendants sought to and did benefit themselves at the expense of the minority shareholders. Its factual finding that Wren, Javva, and Catalyst constituted a control group was fully supported and not clearly wrong. The Chancery Court also correctly held that Plaintiffs had standing to bring a direct expropriation claim under *Carsanaro v. Bloodhound Technolgies, Inc.*, 65 A.3d 618 (Del. Ch. 2013), which is consistent with *Gentile v. Rosette*, 906 A.2d 91 (Del. 2006).

7. Denied. While attorneys' fees are not an adequate remedy for Defendants' misconduct, which requires an award of damages to Plaintiffs here, the Chancery Court correctly recognized that it wielded broad authority to award attorneys' fees and costs in this case. The court, however, erred when it failed to award all of the fees, as calculated on a quantum meruit basis, flowing from Defendants' proven breaches of fiduciary duty. Indeed, the Chancery Court's award amounted to only a small fraction of the actual fees and costs incurred by Plaintiffs and their counsel, and allowed Defendants to retain nearly all of the nearly $120 million, excluding interest, of their ill-gotten gains.

ARGUMENTS ON APPEAL

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

A. Standard And Scope Of Review

The parties agree that "[w]hether the [Chancery] Court was required to award disgorgement or resciss[ory] damages is a question of law reviewed *de novo*." Def. Br. 24. Plaintiffs' opening brief demonstrated the Chancery Court's legal error because its findings that Defendants "breached their fiduciary duties" through a "grossly inadequate process" and "bad faith," "knowing," and "intentional" misconduct, Op. 1, 7, 51, 118-23; Att'y Fees Op. 6, required disgorgement or rescissory damages as a matter of established Delaware law, Pl. Br. 14-22. Defendants attempt to recast this issue as implicating an "abuse of discretion" standard of review, but, as Defendants recognize, that standard is inapplicable to "question[s] of law." Def. Br. 24. In all events, a trial court "by definition abuses its discretion when," as the Chancery Court did here, "it makes an error of law." *Koon v. United States*, 518 U.S. 81, 100 (1996).

B. Merits Of Argument

1. The Chancery Court's Findings Require Damages

As explained, the Chancery Court's findings that Defendants "breached their fiduciary duties" to Plaintiffs, including the duty of loyalty, through a "grossly inadequate process" and "bad faith," "knowing," and "intentional" misconduct, Op. 1, 7, 51, 118-23, alone require disgorgement of $118.6 million plus interest of

Defendants' ill-gotten profit or rescissory damages of at least $17.8 million plus interest for their expropriation of Plaintiffs' equity, *see* Pl. Br. 14-22. "Delaware law dictates that the scope of recovery for a breach of the duty of loyalty is not to be determined narrowly," *Thorpe v. CERBCO, Inc.*, 676 A.2d 436, 437, 445 (Del. 1996) *("Thorpe II")* (requiring defendants "to disgorge any benefits emanating from" breach of duty of loyalty) (quoted at Pl. Br. 15-16), and that, "'[i]n determining damages, the powers of the Court of Chancery are very broad in fashioning equitable and monetary relief under the entire fairness standard as may be appropriate, including rescissory damages," *Int'l Telecharge, Inc. v. Bomarko, Inc.*, 766 A.2d 437, 440 (Del. 2000) ("*Bomarko II*") (awarding rescissory damages) (quoted at Pl. Br. 16-17)). Thus, where a breach of the duty of loyalty has been proven, courts should "award[] damages designed to eliminate the possibility of profit flowing to defendants from the breach.'" *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1154 (Del. Ch. 2006) (awarding rescissory damages) (quoted at Pl. Br. 15).

In fact, the "standards evolved" in Delaware law "*require* that a fiduciary not profit personally from his conduct, and that the beneficiary not be harmed by such conduct." *Thorpe II*, 676 A.2d at 445 (emphasis added). This "rule, inveterate and uncompromising in its rigidity," rests upon "a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation." *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

Just last month, the Chancery Court relied upon and quoted the same

Delaware authorities that Plaintiffs invoked in their opening brief to award more than $148 million to a group of stockholder plaintiffs for a proven breach of the duty of loyalty. *See In re Dole Food Co. S'holder Litig.*, 2015 WL 5052214, at *44-45 (Del. Ch. Aug. 27, 2015) (quoting *Thorpe II, Bomarko II*, *Gesoff*, and *Guth*). The plaintiffs in *Dole Food* challenged a transaction through which the controlling stockholder purchased all of the company's stock held by other stockholders. The *Dole Food* court concluded that the process leading to the transaction—which was infected by "misrepresentation, self-dealing, and gross and palpable overreaching"—was not fair, *see id.* at *26-44, but that the price "may have fallen within the lower end of a range of fairness," *id.* at *34. Despite this conclusion regarding the price, the court reached the "unitary determination" that the transaction was "unfair." *Id.* at *37-38.

Turning to the remedy, the court noted that because "uncertainties in awarding damages are generally resolved against the wrongdoer," Delaware law "does not require certainty in the award of damages," but allows a "[r]esponsible estimate[] that lack[s] mathematical certainty." *Id.* at *44. The court further held that, under the Delaware cases cited above, "the stockholders are not limited to an arguably fair price" but, instead, "are entitled to a *fairer* price." *Id.* at *2, *45 (emphasis added). It therefore awarded plaintiffs $148,190.590.18 in damages to remedy Defendants' breach of the duty of loyalty. *Id.* at *2, *47.

Here, as Plaintiffs have explained, the Chancery Court departed from these governing rules because its own findings required disgorgement of $118.6 million

plus interest of Defendants' ill-gotten gains or at least rescissory damages, which the court at a minimum indicated would be "approximately $17.8 million, plus interest." Op. 129; Pl. Br. 16-17, 21-22. By failing to enter such an award, the Chancery Court not only contravened Delaware law but also shifted the "uncertainties in awarding damages" away from Defendants, "the wrongdoer[s]," and to Plaintiffs, the victims, *Dole Food*, 2015 WL 5052214, at *44-45, on a record the court found "was severely hampered by" Defendants' egregious misconduct, Op. 118-19; Pl. Br. 17. This Court should reverse. *See* Pl. Br. 14-22.

2. Defendants Fail To Refute The Chancery Court's Error

Defendants offer four arguments in an attempt to defend the Chancery Court's refusal to award disgorgement and damages, all of which fail. *First*, Defendants attempt to recast the question presented as "discretionary," and suggest that the Chancery Court "has broad discretion to determine the appropriate remedy under the entire fairness standard." Def. Br. 24-25. But the question Plaintiffs have presented is purely legal: whether the Chancery Court contravened the "standards" of Delaware law that "*require* that a fiduciary not profit personally from his conduct, and that the beneficiary not be harmed by such conduct." *Thorpe II*, 676 A.2d at 445 (emphasis added); *see* Pl. Br. 14-22. Moreover, an error of law such as this "by definition" is an abuse of discretion. *Koon*, 518 U.S. at 100. In all events, the cases Defendants cite stand for the unremarkable proposition that a court has discretion to choose *among* available remedies, including disgorgement and damages, for a proven breach of the duty of loyalty.

None so much as supports, much less establishes, Defendants' counterintuitive and untenable position that a court should exercise its discretion to *deny* any and all damages remedies where, as here, such a breach has been proven.[1]

Second, Defendants double down on their position that the court's denial of damages was "discretionary" and suggest that the court properly based that denial on four "fact findings." Def. Br. 27. Defendants first suggest that "Plaintiffs suffered no economic harm from the Recapitalization" because the price was "fair." *Id.* But whether Plaintiffs suffered economic harm is legally irrelevant: the inquiry for a breach of the duty of loyalty focuses on the benefits retained by Defendants, the wrongdoers, rather than the harm to Plaintiffs. Pl. Br. 18-20. Moreover, Plaintiffs *were* harmed by Defendants' grossly unfair process and years-long concealment, regardless of the "fairness" of the price: Defendants' circumvention of Plaintiffs' preemptive rights and expropriation of their equity diluted Plaintiffs' ownership share and dramatically shrank their portion of the merger proceeds. *Id.* In all events, Defendants' premise is untenable because the court's conclusion that the price was fair is reversible legal error. *See infra* Part II.

Defendants' other three purported "findings" only underscore the court's legal error in failing to award disgorgement or damages:

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[1] *See Bomarko II*, 766 A.2d at 440-41 (upholding award that might over-compensate plaintiffs under "potentially harsher rules" for breaches of the duty of loyalty); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983) (remanding "to fashion any form of equitable and monetary relief" for proven violation); *Gesoff*, 902 A.2d at 1154 (entering award "designed to eliminate the possibility of profit flowing to defendants from the breach of the fiduciary relationship"); *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 464 (Del. Ch. 2011) (same).

- The court's belief that Defendants had "no duty to allow Plaintiffs to participate" in the Transactions, Def. Br. 27, is irreconcilable with its recognition that Plaintiffs held preemptive rights, including the right to participate pro rata, Op. 29 n.100—rights that Defendants do not so much as *mention*, Def. Br. 27; *see also* Pl. Br. 44.
- The court's statement that calculating damages is "too speculative" because the record contains "little evidence," Def. Br. 27, is legal error that disregards its finding that the record was "severely hampered by" Defendants' misconduct, Op. 118-19, ignores that any uncertainty must be held against Defendants, and contravenes the requirement to make a responsible estimate of damages, *see* Pl. Br. 14-22. It also entirely ignores the undisputed evidence that Plaintiffs were "ready, willing, and able" to invest more at the time of the Transactions if provided the opportunity and that Defendants did invest when provided the information and opportunity wrongfully denied to Plaintiffs. Op. 43.[2]
- That the Transactions increased SMC's "worth," Def. Br. 27, is precisely the point: Defendants' egregious misconduct captured all of that value and expropriated it away from Plaintiffs, *see* Pl. Br. 14-22.

Third, Defendants unsuccessfully attempt to distinguish the controlling

[2] Indeed, on this record, there is no other possible evidence that Plaintiffs could have offered. The Chancery Court found that Defendants intentionally froze out Plaintiffs, denied them the opportunity to participate in the Recapitalization even though they were "ready, willing, and able" to do so, and concealed material information for several years. Op. 43-45, 93-94.

Delaware precedents, arguing that they all "involved diversions of corporate opportunities away from the corporation or misleading pre-transaction communications that induced stockholders to forfeit rights." Def. Br. 27. But Defendants offer no explanation as to how these remedies can be available against a wrongdoer who issues a "misleading pre-transaction communication[]," but are categorically unavailable against Defendants who made *no* pre-Transaction communications and whose sole post-Transaction communication was the "materially misleading" and "inadequate" Fall 2002 Update. Op. 44-45, 93-94; *see* Def. Br. 27. Moreover, Defendants *did* usurp the opportunity to invest from Plaintiffs. In all events, *none* of the governing cases turned on Defendants' suggested limitation. Instead, those cases universally establish that "the scope of recovery for" *any* "breach of the duty of loyalty is not to be determined narrowly," *Thorpe II*, 676 A.2d at 445 (cited at Def. Br. 27), and may include "disgorgement," *In re Mobilactive Media, LLC*, 2013 WL 297950, at *23 (Del. Ch. Jan. 25, 2013) (awarding disgorgement) (cited at Def. Br. 25-28), and/or "rescissory damages," *Bomarko II*, 766 A.2d at 440 (cited at Def. Br. 27), as these remedies serve the salutary purpose of "eliminat[ing] the possibility of profit flowing to defendants from the breach," *Gesoff*, 902 A.2d at 1154 (cited at Def. Br. 25).

Finally, Defendants jump to the defense of the Chancery Court's denial of a remedy on Plaintiffs' discrete unjust enrichment claim, *see* Def. Br. 29-30, but both of their arguments merely echo the court's legal errors. Defendants, like the court, collapse the unjust enrichment claim into the breach of fiduciary duty

claim—but, as Plaintiffs have explained, those distinct claims involve *different* "theories of liability" and "elements of proof." *Id.* 30; *see* Pl. Br. 21-22. Thus, there are two *independent* paths to recovery, and the court's rejection of the unjust enrichment claim was error, *see* Pl. Br. 21-22.

Moreover, Defendants repeat the court's flawed reasoning that Plaintiffs have failed to prove an essential element of their unjust enrichment claim. Defendants argue that Plaintiffs did not prove an "impoverishment" because the Court found that the price was fair and Plaintiffs received "the substantial equivalent in value of what they had before." Def. Br. 30. But the "[i]mpoverishment" element of an unjust enrichment claim need not entail a "financial loss" to Plaintiffs, but instead their "being deprived of the benefit unjustifiably conferred upon" Defendants. *Nemec v. Shrader*, 991 A.2d 1120, 1130 n.37 (Del. 2010). Plaintiffs suffered an impoverishment because Defendants "deprived" Plaintiffs of the opportunity to exercise their preemptive rights and expropriated their equity—a benefit "unjustifiably conferred upon" Defendants by their egregious misconduct. *Id.*; *see* Pl. Br. 21-22.[3] In any event, the Court's fair price analysis is legally erroneous. *See infra* Part II. The Court should reverse the Chancery Court's legal error in denying Plaintiffs any damages to compensate them for *either* Defendants' wrongdoing or their losses. Pl. Br. 14-22.

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[3] Defendants suggest in passing that Plaintiffs "waived" their request for the damages on "three discrete harms" identified by the Chancery Court. Def. Br. 29. No waiver occurred: Plaintiffs presented this request below, and the court referred to these harms in its opinion. A947, 1272-85; Op. 39, 42-43, 52. Defendants' undeveloped suggestion that these claims are "derivative," Def. Br. 29, is itself waived and wrong in any event, *see infra* Part V.

II. PLAINTIFFS ARE ENTITLED TO A DAMAGES AWARD FOR THE DISCLOSURE VIOLATION THAT DEFENDANTS DO NOT DISPUTE THEY COMMITTED

A. Standard And Scope Of Review

The Chancery Court rejected Plaintiffs' disclosure claim in a one-sentence footnote based on its legal error that Plaintiffs were required to show harm "separate from the overall Recapitalization" and, thus, that the disclosure claim was subsumed within "the entire fairness analysis." Op. 93 n.325; Pl. Br. 40-44. This Court reviews such legal determinations de novo. *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 48 (Del. 2006). Defendants therefore are simply incorrect that Plaintiffs seek to challenge factual findings related to their disclosure claim. *See* Def. Br. 41. Indeed, as explained below, *see infra* Part III.B, the facts that even Defendants do not dispute establish a clear-cut disclosure violation that warrants an award of damages as a matter of law.

B. Merits Of Argument

Defendants engaged in a deliberate, years-long campaign to conceal the key terms of the Transactions from Plaintiffs. *See* Pl. Br. 40-44; Def. Br. 41-42. Defendants concede that they did not make any disclosures prior to the Transactions—and they do not contest the Chancery Court's finding that their sole post-Transactions disclosure, the Fall 2002 Update, was "materially misleading" and "inadequate" because it failed to include the key terms of the Transactions. Op. 44-45, 93-94; *see also* Pl. Br. 40-44; Def. Br. 41-42. Defendants, moreover, do not dispute that they concealed the Transactions for years, creating an "informational

vacuum" that "severely hampered" the evidentiary presentation at trial. Op. 118-119, 112; *see also* Pl. Br. 40-44; Def. Br. 41-42. And Defendants do not even address Plaintiffs' attestations that they were "ready, willing, and able" to participate in the Transactions and that, had they been made aware of Defendants' actions, they would have brought an action for rescission, enforced their preemptive rights, and invested in SMC. Op. 43; Pl. Br. 40-44; Def. Br. 41-42.

These undisputed facts establish that Defendants committed a disclosure violation. *See* Pl. Br. 40-44. Moreover, as Plaintiffs have explained, this violation "logically and directly" harmed Plaintiffs, *In re Tyson Foods, Inc.*, 919 A.2d 563, 602 (Del. Ch. 2007), and warrants rescissory damages of at least $48.9 million plus interest or, at the very least, the "$17.8 million, plus interest" that the Chancery Court found Plaintiffs "would have received in the Akamai Merger had they participated in the [Recapitalization] pro rata," Op. 129; *see* Pl. Br. 40-44.[4] Thus, the Chancery Court erred as a matter of law when it rejected Plaintiffs' disclosure claim in a one-sentence footnote. *See* Pl. Br. 40-44.

Defendants offer three arguments in an attempt to avoid paying damages for their proven disclosure violation, all of which miss the mark. *First*, Defendants argue that Plaintiffs were not entitled to a remedy for Defendants' proven breaches of fiduciary duty because "there is no per se rule of damages" and because "[n]o

[4] The $17.8 million in damages is based on the fundamentally flawed Dwyer valuation Defendants relied upon. Op. 129. The $48.9 million in damages compensates Plaintiffs for the damages they suffered from the unfair price ($45.6 million) and the lost opportunity to invest ($3.3 million), if the Recapitalization had occurred at a fair price. *See* A586-87; A1270-71.

deprivation of economic rights occurred here." Def. Br. 41-42. But the cases Defendants cite establish that damages must be awarded where, as here, harm has been shown. *See, e.g.*, *In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 766, 776 (Del. 2006) (cited at Def. Br. 42); *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 147 (Del. 1997) (cited at Def. Br. 41). Moreover, the Chancery Court's findings establish "economic harm" to Plaintiffs. Perhaps most obviously, Plaintiffs were "ready, willing, and able" to participate in the Transactions, Op. 43, and twenty-two Plaintiffs held preemptive rights entitling them to do just that, Pl. Br. 42. Defendants' disclosure violation therefore prevented Plaintiffs from "participat[ing] in the Recapitalization pro rata," which would have yielded them "approximately $17.8 million, plus interest" in the eventual Akamai Merger. Op. 129; *see* Pl. Br. 42. Defendants' concealment also foreclosed Plaintiffs from bringing an action for rescission in 2002, and forced them to litigate this case years later in an "informational vacuum" that "severely hampered" the fair price evidence at trial. Op. 118-19, 122; Pl. Br. 43.

Second, Defendants contend that the Chancery Court was correct in denying a remedy because Plaintiffs did not prove "harm distinct from any harm suffered in the Recapitalization" or "damages separately attributable to their disclosure claim." Def. Br. 42. This is wrong for at least two reasons. As an initial matter, Delaware law does not require that Plaintiffs prove "harm separate from" other causes of action to recover on a disclosure violation. Pl. Br. 43-44. Rather, it demands only that the damages awarded "arise logically and directly from the lack of disclosure."

Tyson Foods, 919 A.2d at 602. And here, the harm suffered by Plaintiffs arises directly from Defendants' failure to disclose "who was receiving the convertible preferred stock and on what terms." Op. 4; Pl. Br. 42-44. Moreover, certain harms suffered by Plaintiffs, including the circumvention of their preemptive rights and the prejudice to their litigation rights, were "separate from the overall Recapitalization," Op. 93 n.325, and thus entitle Plaintiffs to damages under Defendants' own theory, Pl. Br. 42-44; Def. Br. 42.

Finally, Defendants contend that Plaintiffs failed to prove harm because they "neither pled nor proved violations of any contractual preemptive rights." Def. Br. 42. This is both irrelevant and incorrect. Plaintiffs properly raised their inability to enforce their preemptive rights as part of their disclosure claim given that Defendants' concealment prevented them from enforcing these rights in 2002. Moreover, as part of their disclosure claim, Plaintiffs *did* prove that Defendants intentionally circumvented their preemptive rights. *See* Pl. Br. 42-44. Indeed, as explained, *see id.* 40-44, Plaintiffs held preemptive rights, Op. 29 n.100, but Defendants intentionally prevented Plaintiffs from "participat[ing] in the Recapitalization pro rata," *id.* 129, even though Plaintiffs "were ready, willing, and able" to exercise their preemptive rights to do so, *id.* 43. The Court should reverse the Chancery Court's cursory rejection of the disclosure claim and award Plaintiffs rescissory damages of at least $48.9 million plus interest or, at an absolute minimum, $17.8 million plus interest, regardless of its resolution of any other issue presented in this appeal. *See* Pl. Br. 40-44.

III. THE CHANCERY COURT ERRED IN DENYING DAMAGES UNDER THE ENTIRE FAIRNESS STANDARD

A. Standard And Scope Of Review

Defendants contend that Plaintiffs' challenges to the Chancery Court's entire fairness analysis are fact-based and thus must be reviewed under a clearly erroneous standard. Def. Br. 31. This is incorrect because all three of Plaintiffs' arguments present purely legal questions. *First*, whether the Chancery Court improperly shifted the burden to Defendants poses a legal question. *Tri-State Vehicle Leasing, Inc. v. Dutton*, 461 A.2d 1007, 1008 (Del. 1983) (per curiam) (trial court committed "an error of law" when it "improperly allocated the burden of proof"). *Second*, whether the Chancery Court wrongly excluded non-speculative acquisitions is also a question of law. *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 290 (Del. 1996) ("[the] refusal to include . . . new business plans" was "legal error"). *Third*, the Chancery Court's improper exclusion of management valuations and projections and eschewal of any valuation method that used forward-looking figures likewise implicates a legal question. "In resolving issues of valuation the Court of Chancery undertakes a mixed determination of law and fact." *Kahn v. Lynch Commc'n Sys., Inc.*, 669 A.2d 79, 87 (Del. 1995). As a matter of law, the trial court's valuation "must include proof of value by any techniques or methods which are generally considered acceptable in the financial community." *Weinberger*, 457 A.2d at 713. Thus, to the extent any of the Chancery Court's factual findings were "predicated upon its erroneous legal theory," they are not accorded deference. *Cede*, 684 A.2d at 301.

B. Merits Of Argument

This case is marked by a "fair price inquiry" that was "*severely hampered*" by Defendants' egregious misconduct. Op. 118-19 (emphasis added). The Chancery Court held that Defendants engaged in "a grossly inadequate process" and a pattern of "bad faith," "knowing," and "intentional" misconduct. *Id.* 1, 7, 51, 118-23; Att'y Fees Op. 6. In such circumstances, Plaintiffs are entitled not only to a "fair price," but to "a fairer price designed to eliminate the ability of the defendants to profit from their breaches of the duty of loyalty." *Dole Food*, 2015 WL 5052214, at *2, *45. The Chancery Court's decision fell far short of providing even a fair price, never contemplated providing Plaintiffs with the fairer price to which they are entitled, and committed three distinct legal errors in the process.

1. The Chancery Court Misapplied The Entire Fairness Burden

The Chancery Court improperly relieved Defendants of their fair price burden by effectively shifting to Plaintiffs the task of building a record out of evidence tainted by Defendants' misdeeds. Pl. Br. 24-26. The Chancery Court's error led to the drastic consequence of concealing Defendants' complete failure of proof and crediting Defendants' backward-looking, litigation-driven valuation analysis that contravenes clear Delaware law. *Id.* 25-27. Plaintiffs' analysis, by contrast, followed Delaware precedent and considered the contemporaneous valuations and non-speculative acquisitions in the valuation of SMC. On this record, which demonstrates a price "so intertwined with" and so "infect[ed]" by the

process, the Chancery Court committed legal error in determining that the price was fair. *Kahn v. Tremont Corp.*, 694 A.2d 422, 432 (Del. 1997); *Bomarko, Inc. v. Int'l Telecharge, Inc.*, 794 A.2d 1161, 1183 (Del. Ch. 1999).

Rather than grapple with these inconsistencies, however, Defendants focus on reframing the Chancery Court's holdings and Plaintiffs' arguments on appeal. For instance, Defendants assert that the court did not relieve them of their burden because it stated that "'the burden to establish the entire fairness of the Recapitalization is on the Defendants.'" Def. Br. 31 (quoting Op. 86). But Plaintiffs do not claim that the court *misstated* the burden, but instead *misapplied* it, Pl. Br. 24-26—an issue Defendants fail even to address, Def. Br. 31-32.

Defendants further argue that even if the court did misallocate the burden of proof, the "impact . . . is questionable" because the valuation evidence is not in a "state of equipoise." *Id.* 32. This contention misunderstands Plaintiffs' argument: once again, the court's error lies not in an improper application of the preponderance standard, but in its misallocation of the burden of proof. The court thus faulted *Plaintiffs* for the "informational vacuum" caused by Defendants' misdeeds, Op. 122, and credited Defendants' post hoc, litigation-driven valuation that departed from their real-time view of SMC's value, Pl. Br. 25. In other words, the court held Plaintiffs accountable for the "speculative nature of the offered proof" on fair price, Op. 131, and enabled Defendants, who caused these evidentiary gaps, to avoid paying *any* damages for their proven misdeeds. Such a result would encourage faithless fiduciaries to hide their misconduct.

Finally, Defendants contend that Plaintiffs seek to create a rule "that once the process exceeds some threshold of unfairness the price becomes per se unfair." Def. Br. 32. Not so; rather, Plaintiffs highlight the Chancery Court's unique findings that Defendants' unfair process "severely hampered . . . the fair price inquiry presented at trial" and created an "informational vacuum" that rendered litigation exceedingly difficult. Op. 118-19, 122. Moreover, even on Defendants' own description, *see* Def. Br. 32-33, this Court's decision in *Tremont* confirms that where, as here, the process actually infects the price, it is error to treat the two as distinct inquiries because the "fair" price does not necessarily "save the result." 694 A.2d at 432. The Chancery Court's misapplication of the burden of proof improperly foreclosed the damages that Plaintiffs are due and prescribes reversal. *See* Pl. Br. 24-26.

2. The Chancery Court Erred In Valuing SMC Without The "Not Speculative" e-Media And NaviSite Acquisitions

The Chancery Court held, and Defendants do not dispute, that the acquisitions of assets from e-Media and NaviSite were "not speculative" at the time of the Transactions. Op. 100. The court therefore erred when it excluded these "not speculative" acquisitions from its valuation. *See Cede*, 684 A.2d at 290 (reversing as "legal error" the court's "refusal to include in the valuation calculus" the "new business plans and strategies" "which the court found were not speculative"). On this basis alone, reversal is warranted. *See* Pl. Br. 27-32.

Defendants do not contest that including e-Media and NaviSite in their own

expert's valuation method would yield a value of $21.2 million for SMC: five times Dwyer's valuation. Pl. Br. 31; Def. Br. 35-37. Rather, Defendants concoct several arguments to justify the exclusion, none of which is persuasive. Defendants first contend that the Chancery Court correctly excluded the value of these acquisitions because "SMC 'did not have the capital needed to fund either of the e-Media or NaviSite acquisitions.'" Def. Br. 36 (quoting Op. 100). But this untenable position contradicts commonplace corporate finance practices and established Delaware law. Pl. Br. 29-30. Indeed, businesses *ordinarily* do not have on hand the capital needed to fund acquisitions, and must raise money to complete them. Thus, Defendants' proposed rule would depart from nearly universal business practice and read the requirement to include non-speculative acquisitions in corporate valuations right out of Delaware law.

Indeed, the only support the Chancery Court and Defendants marshaled for this unworkable outcome is a single, out-of-context sentence from *Delaware Open MRI Radiology Associates, P.A. v. Kessler*, 898 A.2d 290 (Del. Ch. 2006). *See* Op. 100-01; Def. Br. 35-36. But *Kessler* establishes *Plaintiffs*' position: far from imposing a cash-on-hand requirement, *Kessler* specifically *included* in its valuation expansion plans for which "[t]he financing needed" "was not secured until" ten months after the challenged merger. 898 A.2d at 318; Pl. Br. 28.

Decisions of this Court only confirm Delaware law's rejection of Defendants' position. Indeed, *Weinberger* focuses on whether the acquisition was "the product of speculation," and did not even *consider* whether the company had

cash on hand to complete it. 457 A.2d at 713; *see also Dole Food*, 2015 WL 5052214, at *36 ("'[W]hen 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.'" (quoting *Kessler*, 898 A.2d at 315 n.51)).

Citing no authority, Defendants next contend that, because they provided the "new money," SMC should be valued without the non-speculative acquisitions. Def. Br. 36. This argument highlights Defendants' fundamental misunderstanding of their fiduciary duties and the reality of the Transactions: SMC, not Defendants, acquired e-Media and NaviSite. Defendants' argument is thus a thinly veiled attempt to use their own grossly unfair conduct as a *de facto* end-run around the corporate opportunity doctrine and Plaintiffs' rights.[5] Defendants cannot be allowed to leverage their freeze-out of minority stockholders to retain all of the benefits SMC received in the Transactions. Any such result would encourage directors to violate their fiduciary duties, push through self-funded acquisitions, and reap the benefits that should accrue to the corporation and other shareholders.

Finally, Defendants claim that the exclusion of the e-Media and NaviSite acquisitions was harmless because the Chancery Court concluded that "'the Company's equity still had no value in May and August 2002,' after the

[5] In fact, at trial, Defendant and Board Chairman Dort Cameron testified that it was a "terrible mistake" that Wren, Javva, and Catalyst did not simply "bankrupt" the Company and wipe out the minority stockholders entirely. A753-54.

acquisitions closed." Def. Br. 35, 37 (quoting Op. 116).[6] But this conclusion is itself infected with legal error. The court began with its January enterprise value of SMC (which it erroneously derived solely from SMC's January 2002 LTM revenue, *see infra* Part III.B.3), added the $3.3 million purchase price of e-Media and Navisite, and subtracted the $3.9 million in notes issued to fund the acquisitions. Op. 116 n.389. The court's method thus produced a *fait accompli* that guaranteed that its May and August valuations would mirror its flawed January valuation. Indeed, under this method, virtually *every* acquisition would have a net neutral or net negative impact on a corporation's value, rendering the requirement to include non-speculative acquisitions in valuations a hollow exercise. And this method entirely fails to account for the future value of non-speculative acquisitions and, thus, is legally incorrect. *See Dole Food*, 2015 WL 5052214, at *35 (accounting for acquisitions through incremental cash-flow increases). This Court should reverse.

3. Defendants Advocate For Use Of A Backward-Looking Valuation Method That Ignored Management Projections

The Chancery Court committed further legal errors by ignoring contemporaneous management projections and contemporaneous valuations ranging from $10 million to $25 million, and utilizing a backward-looking LTM as

[6] Defendants also contend that Plaintiffs waived this issue by failing to raise it in their post-trial briefing, Def. Br. 37, but Defendants are mistaken, as Plaintiffs explained in post-trial briefing that their expert "value[d] SMC on May 15, 2002, and July 31, 2002, at $24.43 and $23.61 million, respectively." A629 (Post Tr. Reply Br. at 34 n.39).

the sole means of valuing SMC. Pl. Br. 32-39. This defied Delaware's preference for valuations based on management projections and failed to account for SMC's status as a start-up company with enormous upside potential. *Id.* 32-33.

Defendants do not dispute that the projections were made by management in the ordinary course of business, *id.* 38; that this management team was hand-picked by Defendants, *id.* 37; or that a prior management team prepared the earlier projections that the Chancery Court deemed unreliable. *Id.* Defendants also do not dispute that the "record does not contain any document in which the Board" or any Defendant "expressed . . . disagreement with those projections." *Id.* 31. Instead, Defendants defend the Chancery Court's erroneous departure from contemporaneous management projections by pointing to their expert's chart showing SMC's historical performance compared to projections created largely by a prior management team. Def. Br. 18. But, as the Chancery Court noted in a recent decision cited by Defendants, "[w]hether other, prior executives had or lacked the gift of seeing into the Company's future and predicting the success of its business is less relevant and barely probative of the forecasting capabilities of the pre-Merger management team." *LongPath Capital, LLC v. Ramtron Int'l Corp.*, 2015 WL 4540443, at *11 (Del. Ch. June 30, 2015).

Equally unavailing, Defendants point to cases holding that management projections should be rejected when management themselves considered the projections unreliable, *Doft & Co. v. Travelocity.com, Inc.*, 2004 WL 1152338, at *5 (Del. Ch. May 21, 2004); the projections were prepared outside the ordinary

course of business, *Huff Fund Inv. P'ship v. CKx, Inc.*, 2013 WL 5878807, at *10 (Del. Ch. Nov. 1, 2013); or the projections were crafted by a biased management team concerned with the possibility of litigation, *Longpath*, 2015 WL 4540443, at *10. It remains undisputed that none of these issues plagued the projections here.

Defendants also do not contest that Delaware law and financial literature call for valuing start-up companies based on *projected* earnings. Pl. Br. 33. Nor do Defendants dispute that none of the cases cited by them or the Chancery Court used a backward-looking approach. For example, in *Doft*, the court used a *forward-looking* EDITDA multiple after declining to use DCF. 2004 WL 1152338, at *10-11. There is simply no Delaware precedent that supports using historic revenue figures alone to value a growing company.

To be sure, in two appraisal actions Defendants cite, the Chancery Court eschewed a DCF and other projections-driven valuation methods, relying instead on a market or arms-length transaction price. *LongPath*, 2015 WL 4540443; *Huff Fund*, 2013 WL 5878807. However, because Defendants' conduct here rendered those methods unavailable, these cases are inapposite. Far from "a proper transactional process," *LongPath*, 2015 WL 4540443, at *20, or a process that was "thorough, effective, and free from any spectre of self-interest or disloyalty," *Huff Fund*, 2013 WL 5878807, at *13, the process here was "grossly unfair," Op. 7. Thus, the Chancery Court erred by departing from Delaware precedent relying upon management projections in the context of a forward-looking valuation.

IV. DEFENDANTS OWED FIDUCIARY DUTIES TO PREFERRED A STOCKHOLDERS

By June 25, 2002, all of the Preferred A Plaintiffs executed "irrevocable" Subscription and Surrender Agreements, thus permanently "surrender[ing] for cancellation all of the[ir] Senior Secured Notes." A199-254. In so doing, they relinquished all contractual protections they previously had as debt holders, forfeited their warrants to purchase common stock, and agreed "to bear the economic risk of [preferred stock ownership]." A201. In exchange for converting their debt, the Preferred A Plaintiffs received an equitable interest in SMC with concomitant fiduciary protections. *See Simons v. Cogan*, 549 A.2d 300, 303 (Del. 1988). The Chancery Court therefore erred in finding that the Preferred A Plaintiffs lacked standing to challenge the Transactions and Defendants' subsequent failure to make material disclosures. *See* Pl. Br. 45-47.

In defending the Chancery Court's ruling, Defendants invoke *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171 (Del. 1988). But *Anadarko* is factually inapposite. There, no conversion of debt to equity took place; rather, the plaintiff sought to challenge on a breach-of-fiduciary-duty theory certain contracts approved after the announcement of a stock dividend but before the date on which stock in the spun-off company was distributed. *Id.* at 1172. Moreover, *Anadarko* stands for nothing more than the unremarkable principle that the mere expectation of stock ownership does not imbue one with fiduciary protections. *See id.* In contrast, the Preferred A Plaintiffs had far more than an expectancy interest in SMC's equity. Indeed, they "irrevocabl[y]" relinquished the rights and benefits

attendant to senior secured note ownership in return for fiduciary protections and the chance to capture upside in SMC.

In an analogous context, this Court has stated that if warrantholders wish to possess the rights accorded to stockholders, they must (1) exercise their warrants, and (2) pay the set conversion price per share. *See Aspen Advisors LLC v. United Artists Theatre Co.*, 861 A.2d 1251, 1263 (Del. 2004). Notably, this Court did *not* say that the physical distribution of shares to the warrantholders is also a prerequisite to obtaining stockholder rights. *Id.* So too here. The Preferred A Plaintiffs did everything within their power to convert their notes to preferred shares; there was nothing more they could do. Contrary to Defendants' assertions, nothing more was required for them to obtain fiduciary protections.

Indeed, consider the rule established by the Chancery Court that the Preferred A Plaintiffs only obtained standing to challenge the Transactions upon share issuance. Under this reasoning, a noteholder can irretrievably surrender his contractual rights, stop receiving interest payments on the debt he held, and submit to the economic risk of stock ownership, but receive absolutely no fiduciary protection for as long as faithless directors and insiders decide to delay the issuance of the stock to which he is indisputably entitled, even where, as here, conversion of the debt to equity is a "necessary precursor" to self-dealing transactions. SJ Op. 10. This Court should reverse the Chancery Court and rule that Defendants owed the Preferred A Plaintiffs fiduciary duties.

ARGUMENTS ON CROSS-APPEAL

V. THE CHANCERY COURT PROPERLY HELD THAT PLAINTIFFS' CLAIMS ARE DIRECT

A. Question Presented

Did the Chancery Court properly hold that Plaintiffs' claims for harm independent of injury suffered by the corporation were direct when Plaintiffs proved that Wren, Java, and Catalyst formed a control group and that the Self-Dealing Transactions were approved by a majority-conflicted board of directors?

B. Standard And Scope Of Review

This Court overturns findings of fact only when they are "clearly wrong," and reviews questions of law de novo. *Disney*, 906 A.2d at 48.

C. Merits Of Argument

The Chancery Court correctly held that Plaintiffs' expropriation claim is direct because it seeks recovery for harm suffered by Plaintiffs rather than by SMC. *See* Op. 55-59. It further correctly held that Plaintiffs had standing to assert that claim on two independent bases: that Wren, Javva, and Catalyst formed a control group and that a majority of the directors who approved the Transactions were self-interested. *See id.* Defendants strain to challenge the court's factual findings, but their own arguments confirm the court's conclusions.

1. The Chancery Court Correctly Concluded That Plaintiffs' Claims Are Direct

Whether a challenge to wrongdoing by corporate fiduciaries is direct or derivative turns on two questions: "(1) who suffered the alleged harm (the

corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004). In *Gentile*, this Court held that expropriation claims may be both derivative and direct where the wrongdoing harmed both the corporation and a group of stockholders individually. 906 A.2d at 99-100. The harmed stockholders may maintain a direct action to recover the "improper transfer—or expropriation—of economic value and voting power" by a majority or controlling stockholder. *Id.* at 100. Applying these rules, the Chancery Court correctly held that Plaintiffs' expropriation claim is direct because the Transactions "proportionately diluted the Plaintiffs' stock holdings in the Company" and transferred the lion's share of the economic value and voting power of their equity to Defendants. Op. 59. Such "individual" harm to Plaintiffs gives rise to a "direct" claim. *Id.*

Defendants do not dispute that the Transactions diluted Plaintiffs' equity and shifted virtually all of it to Defendants. Def. Br. 49-52.[7] Rather, Defendants argue that an expropriation claim is direct only where the benefit to the wrongdoer is *identical* to the harm to the victims. *Id.* 50-51. Thus, Defendants contend, Plaintiffs have no direct claims because the Transactions transferred a small portion of Plaintiffs' equity to entities other than Defendants. *Id.* 51; *see* Op. 42.

[7] "Wren, Javva, and Catalyst's fully diluted stock ownership . . . increased from approximately 54% in January to approximately 80% by September." Op. 43. "In contrast, the Plaintiffs' fully diluted ownership decreased from approximately 26% to approximately 2%." *Id.*

Defendants' argument is meritless. The test for whether a claim is direct turns on whether harm was suffered by Plaintiffs "individually," not whether it is precisely coextensive with the benefit extracted by Defendants through their wrongdoing. *Tooley*, 845 A.2d at 1033; *Gentile*, 906 A.2d at 99-100. Nothing in *Gentile* or any other case prevents plaintiffs who have been victimized by breaches of fiduciary duty from recovering simply because the wrongdoers transferred some small amount of dilutive equity to others. Such an absurd and inequitable rule would provide a blueprint for controlling stockholders seeking to benefit themselves at the expense of minority stockholders with impunity. *See Dubroff v. Wren Hldgs., Inc.*, 2011 WL 5137175, at *8 (Del. Ch. Oct. 28, 2011) ("[M]inority shareholders should not be denied a direct equity dilution claim" simply because the control group allowed a small amount of the expropriated equity to go to others.); Op. 59.

Indeed, in *Gentile*, this Court warned against overly formalistic approaches that deny recovery to minority stockholders harmed by a controlling stockholder's unfair expropriation. 906 A.2d at 102. Rejecting the argument by defendants in that case that public stockholders must be reduced from a majority interest to a minority interest to bring a direct expropriation claim, this Court stated that "[s]uch a requirement distracts from—and obscures—the nature of the harm inflicted upon the minority," and "denigrates the gravity of the fiduciary breach and condones overreaching by fiduciaries." *Id.* "No principle of fiduciary law or policy justifies any condonation of fiduciary misconduct," this Court stated, holding that "[t]he

harm to the minority shareholder plaintiffs resulted from a breach of a fiduciary duty . . . not to cause the corporation to effect a transaction that would benefit the fiduciary at the expense of the minority stockholders." *Id*. at 102-03.

Defendants' arguments contravene post-*Gentile* Delaware case law. In *Gatz v. Ponsoldt*, 925 A.2d 1265, 1268 (Del. 2007), this Court allowed a *Gentile* claim where the controlling stockholder cashed out his stock and caused the corporation to "convert his de facto stock control . . . into an absolute majority interest that simultaneously was transferred to" an outsider. In *Carsanaro*, the Chancery Court permitted a *Gentile* claim where three funds comprising a control group invested in preferred stock rounds, with some dilutive equity going outside the control group, but where minority stockholders had no opportunity to invest. 65 A.3d at 631-34.

The cases Defendants cite in support of their argument actually refute it. In *Feldman v. Cutaia*, 956 A.2d 644, 657-58 (Del. Ch. 2007), *aff'd*, 951 A.2d 727 (Del. 2008), nobody received an exclusive benefit; rather, *all* of the stockholders received the same prior knowledge of and opportunity to participate in the relevant transaction and a great number of them did. And in the pre-*Gentile* case *In re Tri-Star Pictures, Inc., Litigation*, 634 A.2d 319, 330 (Del. 1993), which Defendants cite for its reference to "increas[ing] the value of the controlling stockholder's interest at the sole expense of the minority," this Court was only illustrating how a direct expropriation claim against a controlling stockholder differed from, *e.g.*, a

claim alleging corporate waste, in which "the value of *all* stockholders' interests" are "diminishe[d] . . . *equally*" (emphasis added), and thus is derivative.[8]

The facts in this case could not be more different. Here, the minority stockholders had no opportunity to invest in the massively dilutive Preferred B-1, notwithstanding that many of them had preemptive rights. Op. 29 n.100, 59, 62-66.[9] It would be inequitable, and contrary to *Gentile* and its progeny, to find that Plaintiffs here could not bring a direct *Gentile* claim against the control group.[10]

Finally, Defendants assert that the court erred in its fact-bound conclusion that Plaintiffs' *Gentile* claims were direct, because of its price analysis, but that argument is wrong. *Gentile* held that the "harm to the minority shareholder plaintiffs" in direct cases "result[s] from . . . caus[ing] the corporation to effect a transaction that would benefit the fiduciary at the expense of the minority

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[8] *See also Gatz*, 925 A.2d at 1277 (citing *Tri-Star*'s holding that all shareholders were not affected equally because the controlling stockholder did not suffer a dilution proportionately with the minority). Defendants also cite *St. Clair Shores General Employees Retirement System v. Eibeler*, 745 F. Supp. 2d 303, 313 n.10 (S.D.N.Y. 2010), in which the court, in dicta, noted the plaintiffs had not alleged the defendants were the "*sole* beneficiary of the options grants." Yet the *St. Clair* court was highlighting that the options grants at issue were widely offered beyond the defendants. Here, in contrast, Defendants reserved the Preferred B-1 to themselves.

[9] The Preferred B-1 comprised 51% of SMC's total equity when issued during the Recapitalization. Op. 42. Defendants half-heartedly suggest that Plaintiffs have no direct expropriation claim because not all Defendants expropriated from Plaintiffs to exactly the same extent, but that is only because Catalyst did not exercise its secret, exclusive 90-day option.

[10] Of the equity that went to non-Defendants, e-Media's parent received Preferred B-2 representing 2.6% of SMC—after Defendants improperly transferred most of the equity that had been reserved for e-Media to Wren and Javva. Op. 42. The Preferred A Plaintiffs, who received a single-digit percentage of the Preferred A stock after they agreed to convert senior secured debt, had no opportunity to invest in the Preferred B-1, nor did the Preferred A stockholders agreement indicate which shareholders were receiving which series of preferred shares or what the various effects of them were. *See Dubroff*, 2011 WL 5137175, at *12; Op. 41.

stockholders." 906 A.2d at 102-03. The Chancery Court's extensive factual findings support liability and damages under *Gentile*, and aiding and abetting. *See* Pl. Br. 14-21; *supra* Part I.[11] Moreover, apart from *Gentile*, Plaintiffs' claims for Defendants' unjust enrichment and disclosure violations are direct because those violations harmed Plaintiffs individually, and damages would go to them. *See* Pl. Br. 21-23, 40-45; *supra* Parts I, II, and n.11. Defendants' disclosure violation uniquely harmed Plaintiffs, including by preventing them from participating in the Recapitalization pro rata—despite their having preemptive rights and being ready, willing, and able to participate—and foreclosing their taking any action for rescission in 2002. The court found damages to Plaintiffs for the disclosure violation could amount to $17.8 million regardless of price. Pl. Br. 40-45; *supra* Part II.[12] The disclosure claim is also direct for the separate reason that it is akin to a disclosure violation when seeking a shareholder vote: Defendants here avoided a shareholder vote only through their collective majority ownership.[13] In all events,

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[11] At the least, the court found that Defendants expropriated Plaintiffs' equity regardless of price: *e.g.*, Defendants permitted nobody else to invest in the Preferred B-1, circumventing the preemptive rights of Plaintiffs who could and would have invested, Op. 29 n.100, 59, 62-66; improperly transferred to Wren and Javva only, without authorization, equity that had been reserved to e-Media, Op. 39; improperly issued a note to Wren, which it later converted to equity, *id.*; and retroactively increased the interest of notes issued to themselves, which they later converted to equity, *id.*

[12] Furthermore, Plaintiffs argued and the Chancery Court found that Defendants had acted in bad faith. *See* A563 (Post Tr. Opening Br. at 88); 5/7/15 Op. 6.

[13] *See* A558-60 (Post Tr. Opening Br. at 83-85). Defendants' cite to *In re J.P. Morgan* is inapt. There, as here, the disclosure claim was direct. The plaintiffs there sought only compensatory damages but could not receive that remedy because they had not suffered individual economic harm. 906 A.2d at 772-74. Here, in contrast, Plaintiffs suffered individual harm and would themselves receive the remedy. Pl. Br. 40-45; s*upra* Part II.

the Court's ruling on fair price constituted legal error and should be reversed. *See* Pl. Br. 23-32; *supra* Part III.

2. The Chancery Court's Factual Finding Of A Control Group Was Not Clearly Wrong

The Chancery Court made detailed factual findings that Wren, Javva, and Catalyst constituted a control group. To prove a control group, Plaintiffs had to show "that the group of stockholders was connected in some legally significant way—e.g., by contract, common ownership, agreement, or other arrangement—to work together toward a shared goal." Op. 61 (citing *Zimmerman v. Crothall*, 62 A.3d 676, 700 (Del. Ch. 2013); *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, at *9-10 (Del. Ch. Aug. 18, 2006); *Emerson Radio Corp. v. Int'l Jensen Inc.*, 1996 WL 483086, at *17 (Del. Ch. Aug. 20, 1996)).

The Chancery Court's extensive findings are more than ample to show a control group. In mid-2001, when Wren, Javva, and Catalyst collectively held a majority of SMC's stock, Catalyst authored an internal memo stating that those three stockholders would take steps to "'effectively give'" them "'*control over the Company*.'" Op. 63 (emphasis added). Catalyst, Wren, and Javva proceeded to execute that general plan. *Id*. Then, during phone calls from December 2001 through August 2002, from which the lone independent director was "knowingly excluded," they set the terms of the Transactions and agreed on a secret, exclusive 90-day option for Catalyst to invest in the Preferred B-1 in exchange for Catalyst's "support [for] the Recapitalization through Shipman's votes on the Board and

Catalyst's stockholder written consent." *Id.* 64-65. They worked together to foreclose minority stockholders from participating in the Preferred B-1 and to render the Recapitalization a "*fait accompli*." *Id.* 66.

The Chancery Court found that, "[p]articularly in light of Catalyst's earlier comments in the [mid-2001] Catalyst memo," Defendants' conduct surrounding the 90-day option "demonstrates an agreement, arrangement, and legally significant relationship among Wren, Javva, and Catalyst . . . to accomplish the Recapitalization," and that those three entities "were united in interest in excluding other investors to maximize their potential return from the Recapitalization." *Id.* 65; *see also Carsanaro*, 65 A.3d at 659 (finding that three funds "worked together to use their board control and status as significant stockholders to cause [the company] to engage in" self-dealing transactions in which the board issued those funds preferred stock, through "actions taken in concert, over time, to direct the company's capital raising in a self-interested way").

Defendants do not dispute the Chancery Court's formulation of the governing test. *See* Def. Br. 52-55. They instead attempt to twist the court's clear factual findings that Wren, Javva, and Catalyst united to control the Company into proof that they were *not* a control group. *See id*. Defendants argue that, because Catalyst "had to be induced to support the Recapitalization with a *quid pro quo*" in the form of the 90-day option, there was no control group. *Id.* 54. This argument makes no sense. Even Defendants recognize that a control group can arise where stockholders controlling a majority of the company's stock "have *agreed* to vote as

one," *id.* 53 (emphasis added)—*e.g.*, have entered into a "*quid pro quo*" for each other's votes, *id.* 53-54. Defendants nonetheless suggest that there was no control group because Catalyst "approved the Recapitalization to further its own interests as a stockholder." *Id.* 54. But, as the court found, Wren, Javva, and Catalyst advanced their interests *through the group*. Op. 62-66.

Defendants' own cited cases confirm that the Chancery Court's factual finding of a control group during the Transactions is correct. In *Williamson v. Cox Communications, Inc.*, the court found a control group where two significant stockholders, neither holding a majority, each appointed one of the corporation's directors, and where the facts, taken together, indicated that they "were in a controlling position and that they exploited that control for their own benefit." 2006 WL 1586375, at *6 (Del. Ch. June 5, 2006). The *PNB* court did not prescribe a rule of law requiring a "blood pact" to prove a control group; it used that language to illustrate the absence of any agreement, or other evidence of acting in concert, among stockholders who happened to be *related*.[14] Here, in contrast, Defendants agreed to work together for their own benefit. Op. 62-66.

3. The Chancery Court Correctly Held that Plaintiffs Had Standing Under *Carsanaro*

The Chancery Court correctly held, in the alternative, that Plaintiffs had standing to bring a direct expropriation claim because a majority of the Board

[14] The *PNB* Court rejected a control group where the largest bloc held by any of the director-defendants was 10.6% and they were "not bound together by voting agreements or other material, economic bonds to justify treating them as a unified group." 2006 WL 2403999, at *1.

members who approved the Transactions "owed fiduciary duties to entities that received benefits from the [Transactions] . . . that were not shared with the Company's other shareholders." Op. 80. Stockholders retain standing to challenge "self-interested stock issuances when the facts alleged support an actionable claim for breach of the duty of loyalty," such as when a controlling stockholder stood on both sides of a transaction, or when "the board that effectuated the transaction lacked a disinterested and independent majority." *Carsanaro*, 65 A.3d at 658.

As the Chancery Court recognized both here and in *Carsanaro*, when fiduciaries can and do use the "levers of corporate control" to expropriate equity from minority stockholders—*i.e.*, to benefit themselves at the minority stockholders' expense—then the minority may bring a direct claim against them. *Carsanaro*, 65 A.3d at 657-61; Op. 67-80. That is the "core insight" of *Gentile*, and it matters not whether the fiduciaries who cause that harm are a controlling stockholder or stockholder-directors. *Carsanaro*, 65 A.3d at 658; Op. 70-71.

Defendants do not challenge the Chancery Court's findings that a majority of the Board was conflicted or that they received benefits not shared with minority stockholders. *See* Op. 77, 79. Instead, they argue that *Carsanaro* would erase the distinction between direct and derivative claims, and is incompatible with *Gentile*. They are wrong on both counts. Defendants assert that *Carsanaro* will "swallow up the continuous ownership rule." Def. Br. 57. But they ignore that the *Carsanaro* court carefully cabined its reasoning: "*Standing will not exist if there is no reason to infer disloyal expropriation*," and gave several illustrative examples.

65 A.3d at 658 (emphasis added). Indeed, *Carsanaro* underscored that the direct claim in that case involved "inter-class conflict in which the directors favored themselves" at the expense of the common stockholders, rather than the interests of the common and a majority of the board being aligned. *Id*. at 660.

Similarly, the Chancery Court in this case found standing for a direct claim because a majority of the Board members who approved the Transactions "owed fiduciary duties to entities that received benefits from the [Transactions] . . . that were *not shared with the Company's other shareholders*." Op. 80 (emphasis added). Just as courts applying *Gentile*'s controlling-stockholder standing test have declined to find standing in cases where, for example, all stockholders received the same prior knowledge of and opportunity to participate in the relevant transaction, *see Feldman*, 956 A.2d at 657-58, so will they be able to apply such limits in the *Carsanaro* majority interested-director context.

Carsanaro is consistent with *Gentile*. *Gentile* itself indicated that the controlling-stockholder expropriation context was only one species of corporate overpayment claim that Delaware law recognizes as being both derivative and direct in character, contemplating that there could be others. 906 A.2d at 99-100. Indeed, its conclusion that "the result here fits comfortably within the analytical framework mandated by *Tooley*" because "[t]he harm to the minority shareholder plaintiffs resulted from" the fiduciary "caus[ing] the corporation to effect a transaction that would benefit the fiduciary at the expense of the minority stockholders," *id*. at 103, clearly encompasses *Carsanaro*.

VI. THE CHANCERY COURT MISCALCULATED ATTORNEYS' FEES AND COSTS

A. Question Presented

Did the Chancery Court miscalculate the attorneys' fees and costs it awarded for Defendants' egregious misconduct?

B. Standard And Scope Of Review

This question is reviewed for abuse of discretion. Pl. Br. 48; Def. Br. 59.

C. Merits Of Argument

While attorneys' fees are an inadequate remedy for Defendants' misconduct, which requires an award of damages to Plaintiffs, under the circumstances, the Chancery Court correctly held that Defendants' "bad faith" and "grossly inadequate process" justify a fee award. Att'y Fees Op. 5-6. The court, however, departed from Delaware law when it failed to award Plaintiffs "all of their attorneys' fees," as calculated on quantum meruit, *Saliba v. William Penn P'ship*, 2010 WL 1641139, at *1 (Del. Ch. Apr. 12, 2010), *aff'd*, 13 A.3d 749 (Del. 2011), and applied its "quasi-*Sugarland*" litigation-recovery-range method, Pl. Br. 48-49.

Defendants agree that the court's unprecedented method, which awarded Plaintiffs less than 20% of the total fees and costs, contravened Delaware law. Def. Br. 63-64. They nonetheless seek to escape any fee award tied to their proven misdeeds, but their arguments fail. *First*, Defendants argue that the court erred in awarding fees because Plaintiffs retained their counsel on contingency and, thus, have not "incurred" any fees that could be "shifted." *Id.* 59-63. However, *Saliba* turned not on who paid the fees, but rather on who "breach[ed] [their] fiduciary

dut[ies].” 2010 WL 1641139 at *1; 13 A.3d at 756-59. *Saliba* thus comports with the myriad Delaware cases that award fees where counsel took the case on contingency and the plaintiffs had not paid out of pocket—cases that Defendants *never* address. *Goodrich v. E.F. Hutton Grp., Inc.*, 681 A.2d 1039, 1046-47 (Del. 1996); *Seinfeld v. Coker*, 847 A.2d 330, 339 (Del. Ch. 2000); *In re First Interstate Bancorp. Consol. S'holder Litig.*, 756 A.2d 353, 358 (Del. Ch. 1999).

Moreover, Defendants never explain why the contingent-fee agreement—to which Defendants are not parties or third-party beneficiaries—should relieve their obligation to “bear the fees and costs made necessary solely by reason of their faithless conduct.” *Saliba*, 2010 WL 1641139, at *1. Under their backwards logic, Defendants would have been required to pay fees if Plaintiffs had paid them, but now may retain a windfall at the expense of Plaintiffs' counsel by virtue of the contingent-fee arrangement. Def. Br. 59-63. Countenancing Defendants' theory risks disincentivizing attorneys from accepting breach of fiduciary duty cases on contingency, thus reducing meritorious suits. Pl. Br. 48-49. Thus, *Defendants*' approach, not Plaintiffs' adherence to *Saliba*, “would misalign the interests of counsel and its clients” to Defendants' undeserved benefit. Def. Br. 48.

Defendants attempt to save their untenable position by pointing to *Scion Breckenridge Managing Member LLC v. ASB Allegiance Real Estate Fund*, 68 A.3d 665 (Del. 2013), *on remand*, 2013 WL 5152295 (Del. Ch. Sept. 16, 2013), *see* Def. Br. 61, but that case is inapposite. *Scion* involved an action to reform a contract, and plaintiffs' counsel took on the case free of charge because its own

drafting mistake spawned the litigation. 68 A.3d at 669-75. Thus, fee-shifting was unavailable because plaintiffs' counsel could not be rewarded for its own original mistake. 68 A.3d at 684; 2013 WL 5152295, at *9-10. Nothing of the sort applies here, where the origins of this litigation lie in Defendants' bad faith misconduct.

Defendants' reliance on *Cantor Fitzgerald, L.P. v. Cantor*, 2001 WL 536911 (Del. Ch. May 11, 2001), for the argument that shifting fees not "incurred" would be improperly "punitive," Def. Br. 62, is similarly misplaced. In *Cantor*, the court held that an award of fees was compensatory, not punitive, and could be granted even in the absence of an award of money damages. 2001 WL 536911, at *3-4. Thus, *Cantor* underscores that a fee award is warranted here as either compensation or equitable relief for Defendants' "totally unjustified" conduct. *Id.*

Second, Defendants argue that because Plaintiffs did not "incur" fees, the court cannot award fees on a quantum meruit basis. Def. Br. 46-48. But Delaware law is clear that where the benefit conferred is unquantifiable, quantum meruit is the appropriate method for calculating a fee award. *First Interstate*, 756 A.2d at 363-64; *In re Dunkin' Donuts S'holders Litig.*, 1990 WL 189120, at *8 (Del. Ch. Nov. 27, 1990); Pl. Br. 49. Defendants finally contend that this case did not create a "benefit." Def. Br. 47. Defendants' cited cases are beside the point: in one, this Court denied attorneys' fees where the plaintiff had *lost*, *Crothall v. Zimmerman*, 94 A.3d 733, 734 (Del. 2014), and in another, the Chancery Court denied fees because the movant had not established bad faith by the wrongdoer, *Ryan v. Tad's Enters., Inc.*, 709 A.2d 682, 706 (Del. Ch. 1996), *aff'd*, 693 A.2d 1082 (Del. 1997).

Defendants' position on appeal is also irreconcilable with their recognition below that the litigation *did* create a benefit. Defendants told the Chancery Court that its "holding the Defendants accountable for their conduct, and thoroughly explaining its rationale," was "significant" because it "vindicated the Plaintiffs' rights" and "publicly rebuked" Defendants. B331; B333; B357. This is the same benefit secured by the plaintiffs in *Saliba*. Still, Defendants fault Plaintiffs for not securing corrective disclosures, governance changes, or modifications to a transaction. Def. Br. 47. But as Defendants have acknowledged, this case "could never have effected . . . any changes to corporate governance or the terms of a transaction," B361, because, due to Defendants' concealment, it was brought after SMC had merged with Akamai. Plaintiffs do not lose their right to fees for failing to achieve benefits that Defendants' misconduct long ago rendered unattainable.

CONCLUSION

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

Dated: September 30, 2015

<u>/s/ Anne C. Foster</u>

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