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MEMORANDUM

To: Special Director Committee

From: Henry Knoblock

Date: October 30, 2008

Re: Reducing Fiduciary Liabilities in Down-round Financings

Since the NASDAQ crash of April 2000, the "down round" has become entrenched as part of the venture capital landscape. A down round is essentially what it suggests: a financing where investors purchase stock from a company at a lower valuation than the valuation placed on the company by earlier investors. As a result, down rounds cause dilution of ownership for existing investors, which can often demoralize the company's founders and employees whose stock or options are worth much less or nothing at all. Down rounds also force existing investors to negotiate with new investors on various features of the financing. However, given the alternatives of going out of business or finding a buyer at the lower valuation, down rounds are often necessary and welcomed.

Before approving a down round, a company's board of directors should carefully deliberate because directors have fiduciary duties to protect the company's shareholders. One step in this process is to obtain an independent valuation or fairness opinion to support the transaction, with the opinion to be rendered by an independent business valuation firm selected by independent and disinterested directors.

In one case, Kalashian v. Advent VI Limited Partnership (Sup. Ct. Calif., No. CV-739278), the board of directors of Alentec Corporation were sued for breach of fiduciary duty and fraud after approving a down round and several subsequent rounds of financing that greatly reduced the ownership percentage of the company's founders in favor of a venture capital fund which owned the company's preferred stock. The court's finding in this case suggests that any stockholder that is subjected to additional dilution mandated by a down- round might have a claim that directors of the company failed to exercise their fiduciary duties and protect the stockholders' interests when the directors voted to approve the transaction.

In documenting the fairness of a dilutive financing, directors should attempt to build steps into their decision making process to support a record of their deliberation and good judgment on behalf of shareholders.

In particular, directors approving a down round should be particularly sensitive to issues involving conflicts of interest. These types of conflicts occur where one or several directors stand to benefit from the down round due to either the dilutive effect it will have on the company' capitalization, or their participation in the down round (typically referred to as an "inside down round"). An inside down round occurs where no outside director is available or willing to invest, and the company offers equity securities to existing investors at a valuation

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that is lower than the valuation of the previous round. The nature of these transactions raise particularly complicated issues with respect to a director/investor's conflicting fiduciary duties.

While these conflicts may result in the inside transaction being voided by a court, there is little guidance with respect to how these conflicts may be avoided in the context of inside down rounds. As a result, a large amount of literature has emerged recently outlining the suggested steps a company should take in order to comply with statutory standards and prevent inside down rounds from being voided. While the literature and advice is fairly consistent, many companies are not taking, or cannot practicably take, these precautionary steps. This Memorandum will provide a discussion of these issues as they relate to Delaware law. Particularly, it will address: (1) the applicable statutory standards a company and its board of directors must meet in order to safeguard an inside down round stock preferred financing; (2) suggested and alternative measures that corporate clients should be advised to follow in order to satisfy these standards; and (3) other alternative factors that may be considered in calculating the viability of the transaction.

FIDUCIARY DUTIES OF DIRECTORS AND "ENTIRE FAIRNESS" UNDER DELAWARE LAW

Directors serve as fiduciaries both to the shareholders and to the companies they serve. This status carries with it compulsory adherence to the duties of loyalty and care[1] Naturally, directors who are investors in an inside down round possess conflicting duties of loyalty and care to parties on both sides of the transaction. Rather than void a transaction that is otherwise fair and acceptable to the corporation, Delaware courts simply subject the entire transaction to a heightened form of scrutiny.[2]

In Delaware, a transaction between a company and one or more of its interested directors is not per se void or voidable solely because of the interested director's participation in the transaction.[3] The statute provides a safe harbor for the company by outlining briefly the requirements for approval of the inside transaction: (1) the interests of the director/officer are disclosed and the transaction is approved by a majority of disinterested directors *or* a majority of the shareholders; or (2) the transaction is "fair" to the corporation at the time it is authorized.[4]

The "fairness" of an interested transaction under the second prong of the Delaware statute is determined by applying the "entire fairness" standard, which consists of an analysis of fair price and fair dealing.[5] The former consideration requires that the price (per share) received be the highest valuation reasonably attainable under the circumstances, while the latter consideration is a function of the time, structure, and manner of the transaction.[6] The burden to demonstrate the fairness of a transaction typically rests on the company conducting it.[7] Certain measures endorsed by the Delaware courts, however, such as establishing an independent committee to evaluate the transaction or gaining the consent of a majority of the minority shareholders, shift this burden to the challenging party.[8] Delaware courts have addressed these factors with respect to general insider transactions, but they have not yet discussed them in the particular context of inside down rounds.[9]

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Cases involving complaints of shareholders' diluted interest resulting from a down round financing tend to be very fact specific and are often "thrown out [by the court] anyway."[10] The cases that do end up being addressed by courts are thus of limited precedential value. As a result, courts rarely address *any* issue resulting from a down round, let alone the particular issue of fairness. Two recent cases, however, grew out of down round financings and are helpful to illustrate the issues that may arise and the actions that should (or should not) be taken in this type of financing arrangement.

Kalashian v. Advent VI, L.P. (*Alantec)*[11]

Alantec Inc., a California corporation, was founded in 1987 as a developer of local area network switching equipment, and quickly attracted the funds of a prominent Silicon Valley venture capital firm (the "VC") in 1988. The VC invested $1.5 million in Alantec's Series A financing and appointed one of the fund's representatives to sit on the Alantec board of directors.

After the Series A financing concluded, an "interim CEO" was approved for Alantec by the VC. In mid-1989, the VC (along with two other well-known capital investment funds)[12] agreed to invest in Alantec's Series B financing on the condition that Alantec agree not to seek any additional sources funding.

Alantec's gross sales from quarter to quarter in 1989 (pre-Series B financing) allegedly increased by almost 100%. At the close of the Series B financing in December 1989, however, the Alantec shares were valued at almost one-third the price agreed to in the mid-1989 term sheet. The VC and the other participating funds appointed additional directors in the Series B round, and attained a majority on the board and a 92% controlling interest in the company.

Soon thereafter, Alantec was allegedly on the brink of insolvency. The board was displeased with Alantec's economic situation and its management, and in June 1990, the board voted to terminate the company's founders. At termination, the founders collectively held all of Alantec's common stock, which was equivalent to an 8% ownership interest. Two new rounds of finance occurred in June 1991 and February 1992, each at a substantially lower valuation than the previous round.[13] During the time period following the founders' departure, Alantec issued options to management and sold millions of dollars of preferred stock. As a result, the common shares were substantially diluted, and the founders equity interest decreased from 8% to .007% by the end of 1991.

In late 1991, Alantec introduced a new product line and sales began to increase dramatically. Alantec's gross profits grew 678.8%, and the company went public in February

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1994. Two years later, Fore Systems, Inc. (now Marconi) purchased Alantec for $770 million, or $70 per share. The diluted founders realized a mere $600,000 on the deal.

The founders filed a complaint against the three investment funds, alleging a conspiracy to commit fraud and breach of fiduciary duty by issuing Alantec preferred stock at less than fair market value and giving it away to management. The plaintiffs sued for $40 million in damages, equal to the amount they would have received if they had retained the 8% ownership. The claims survived a motion for summary judgment and went to trial in 1997, but the case ultimately settled for $15 million in 1999.[14]

Benchmark Capital Partners IV, L.P. v. Vague[15]

Juniper Financial ("Juniper"), a Delaware corporation, was founded in 2000 as a financial service organization specializing in the issuance of credit cards. Benchmark Capital Partners IV ("Benchmark") was Juniper's initial investor, offering up $20 million and $5 million, respectively, in the first two rounds of preferred stock financing.

Juniper quickly realized the need for an additional infusion of capital, and it came to an agreement with Canadian Imperial Bank of Commerce ("CIBC")[16] in June 2001. CIBC agreed to invest $27 million in the form of a mandatory convertible note. CIBC agreed to evaluate Juniper in the meantime and decide whether it wished to acquire the company. In the event CIBC decided not to acquire the company and Juniper subsequently could find no other interested investors, CIBC agreed to provide an additional $118 million in a Series C financing.

CIBC eventually decided not to acquire Juniper, and Juniper called on CIBC to invest in the Series C in July 2001. The financing was duly approved, as per the certificate of incorporation, by a vote of the holders of the Series A and Series B preferred stock (i.e., Benchmark). The financing resulted in CIBC gaining a majority voting power and the right to appoint six of the eleven members of Juniper's board of directors. In addition, Benchmark's preferred stock interests became junior to CIBC's interests.

Benchmark's consent for the Series C financing, however, was obtained on the condition that Juniper's charter include additional protections for Benchmark's preferred stock interests. CIBC agreed, and two provisions resulted: first, junior preferred stockholders were guaranteed a series vote on corporate actions that would "[m]aterially or adversely change the rights, preferences and privileges of the [series of junior preferred stock];"[17] second, the junior preferred stockholders were guaranteed a class vote before Juniper may "[a]uthorize or issue, or obligate itself to issue any other equity security … senior to or on a parity with the [junior preferred stock]."[18] A qualified waiver provision was also included, which permitted a waiver of these protections on a majority vote of a class. This allowed CIBC to waive the provisions on its own by virtue of its sheer volume of holdings in Series C preferred stock. The waiver could only be executed, however, if the contemplated action would not "diminish or alter the

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liquidation preference or other financial or economic rights" of the junior preferred shareholders.[19]

Juniper sought a Series D financing the following year, and CIBC emerged as the only willing investor. The terms of the financing were considerably harsher that the previous round: CIBC agreed to invest $50 million, and the issuance of the Series D stock would give CIBC an additional 23% of Juniper, while reducing Benchmark's equity interests from 29% to 7%.

Juniper and CIBC recognized that the terms of the Series D financing would negate any waiver of Benchmark's class vote, and a Special Committee (the "Committee") was appointed to consider the proposal.[20] The Committee proposed an alternative, in which a subsidiary corporation, Juniper Merger Corporation, was created with the sole purpose of merging with Juniper. Juniper would be the surviving corporation, but its certificate of incorporation would be revised to enable the Series D financing *without* requiring a vote of the junior preferred stockholders. The new certificate of incorporation would effectively (a) convert all of the existing junior preferred stock into *new* Series A preferred and Series B preferred stock, (b) issue warrants for each share of the newly converted stock that would allow the holder to purchase a small amount of common stock, and (c) issue a small fraction of common stock to the holders of this newly converted stock. CIBC and Juniper claimed that Benchmark was only guaranteed a vote on an action that diminished its interests and that resulted from an amendment to the existing certificate of incorporation. Since the merger created a *new* certificate of incorporation, the provision was not applicable and CIBC was authorized to issue the Series D stock.[21]

Benchmark filed for a preliminary injunction in the Delaware Chancery Court to prevent the merger from occurring. Benchmark claimed that it should be entitled to a class vote on the merger because (1) the Series D stock issued would be senior to Benchmark's Series A preferred and Series B preferred stock, and (2) the CIBC waiver was not applicable because the action diminished Benchmark's economic rights.

The court denied the injunction. Relying on the Delaware Supreme Court's decision in *Elliot Associates L.P. v. Avatex Corp.*,[22] the court held that the relative rights of preferred stockholders must be clearly stated, and they will not be presumed or implied. The parties who negotiated the charter are presumed to have full knowledge of the law and recognize that all preferred shareholder rights must be set forth explicitly. The parties failed to provide for the possibility of a merger in the language of the original charter, and the court applied the typical rules for a merger authorization vote: a merger was authorized by a simple majority vote of all outstanding classes of stock.

The issues presented in *Alantec* and *Benchmark* are not unique; they are simply issues that are rarely litigated in a judicial forum. Although these cases are very fact specific, they are exceedingly helpful in some respects. Other companies contemplating similar financings can learn from the mistakes made in these two situations.

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The key concern of any company conducting an inside down round should be to adopt certain practices that will establish the entire fairness of the transaction and, in the event of a court challenge, prevent a judge from being able to void the transaction. Entire fairness, as mentioned above, is demonstrated by satisfying a two-pronged analysis: the challenged party must show that the transaction consisted of fair price and fair dealing. The test essentially amounts to a case-by-case analysis of the facts of each individual situation.

Fair Price

To satisfy the "fair price" prong, companies must establish that the valuation attained is the highest valuation reasonably attainable under the circumstances. This consists of an evaluation of relevant economic factors, such as "assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."[23] *Alantec* provides a great example of the suspect factors that can bring the fair price aspect of the test into question. If a court had an opportunity to evaluate *Alantec*, it would look to two key facts in the evaluation of fair price. First, the challenging shareholders in *Alantec* complained that the Series B financing was one-third lower than agreed to in the term sheet, even though the company had allegedly doubled its gross sales during that time period. If these earnings were accurate, this would probably suggest an unfair pricing problem. This is coupled with the fact that the next two series of financing were both down rounds, and were completed only months before a new product line was released – one that increased profits over 600% and resulted in the $700 million sale. Depending on the VC's knowledge and expectations regarding future earning potential, these two key facts taken into consideration could provide the court with a sufficient basis on which to strike down the transaction.

Fair Dealing

Fair dealing depends on other (and possibly less documented) factors, such as "when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[24] It is important to note at the outset that the *Benchmark* court was considering a motion for a preliminary injunction, and was *not* rendering a judgment on the merits of a breach of fiduciary duty or inside transaction claim. The standard of review for the injunction considered the possibility of Benchmark prevailing on its claims, but ultimately came down to a balancing of the equities in favor of the almost-bankrupt Juniper. Thus, *Benchmark* is still instructive on the "dealing" aspect of the fairness test, even though the court ultimately held in favor of the investors who conducted the Series D financing.[25]

Benchmark implicates the "fair dealing" prong of the fairness test in two significant respects. First, the Series D financing occurred immediately after the orchestrated merger and amendment of the corporate charter. The timing and structure of this transaction clearly indicates a desire to circumvent any legitimate shareholder approval on the matter. In fact, this was conceded as the sole purpose behind the merger.

Second, the special independent committee assigned to advise the board of directors on the logistics of the Series D financing consisted of three members, one of whom Benchmark

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claimed was an interested party.[26] The court noted that although Benchmark challenged the legitimacy of the committee, it was not advanced as an argument in support of the preliminary injunction.[27] If the argument had been presented, the court would have considered the fact that the existence of the interested party on the "independent" committee essentially destroys its proposed function of adding legitimacy to the transaction. Whether this is a determinate factor in finding a violation of fair dealing is another question. This factor may not indicate unfair dealing per se, but the burden of proving fairness would remain with the party whose actions are challenged instead of shifting to the challenging party.[28] In any event, a court considering a similar fact pattern would consider this a negative factor in an evaluation of the fair dealing prong.

PROTECTING INSIDE DOWN ROUNDS

The Delaware safe harbor provision discussed above is automatically triggered if the inside transaction is approved by a majority of shareholders or disinterested directors. If one of these two groups approves the transaction, the entire fairness analysis never materializes. However, inside down rounds, as illustrated in the two cases above, are inherently prone to challenges on the fairness prong. This is because (1) in most inside rounds, it is difficult to identify disinterested directors in order to secure their approval; and (2) most cases, as illustrated by *Alantec* and *Benchmark*, involve an interested shareholder holding a majority of shares. Courts are reluctant to award a safe harbor to transactions with such dubious approval.[29] With that in mind, the suggestions below assume that disinterested director or shareholder approval is not available, and that any future challenge to the financing will be on the grounds of entire fairness.

There has been scant opportunity to gauge courts' reactions to these types of situations, and the procedures suggested by commentators and practitioners with respect to how a company can prevent these financings from being voided are understandably speculative and overly conservative. Ideally, a company that follows *all* of the procedures outlined below could establish the fairness of almost any challenged transaction. The reality is that many companies do not have the human or economic resources to comply with the bulk of these suggestions. In light of this consideration, this section will provide a detailed discussion of all of the suggested measures, but will focus on those measures that are cost effective and easy for a company to implement, and those that are generally indispensable in establishing the fairness of an inside transaction.

Necessary Cost-Effective Options

Every company that is contemplating an inside down round should comply, and should feasibly be able to comply, with the measures listed in this first section. These four steps entail little or no additional cost to the company, both in terms of human and economic resources, and are easy to implement. Each of these measures can also be executed independently without any type of conciliation by the company, such as offering future benefits to the shareholders.

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- **Written Record of Events** – This is the most important step any company can take towards protecting its transaction from future challenges. At the very least, every company should keep accurate minutes of Board of Director's meetings and other types of deliberations. This record will be considered as evidence by a court in the event the financing is challenged. It should reflect that any decision to seek financing through an inside down round was contemplated at length, and was not reached in haste. These board minutes should include, at the very least, specific discussions of alternative financing options and other market factors, as described below.

- **Due Deliberation/Market Checks** – The board should engage in a discussion of the pros and cons of alternative financings, and demonstrate that the decision to conduct the inside down round was the best decision available given the circumstances. The board should back up these discussions by actively monitoring the market. This does not take much in the way of additional resources, but it will provide a solid quantifiable basis for the terms of the financing. In addition, the board should have financing discussions with as many sources as possible. This provides a more reliable point of reference with respect to valuation in the event the financing is challenged. Even if other outside sources of funding are plainly unavailable to the company, as they were in *Benchmark*, it is important to show that these options were at least initially considered. Finally, the board should explore and discuss other alternative arrangements, such as liquidation or sale. All of these actions will help to establish that the inside financing was the best economic option available, and that the board was fully informed and acted in good faith.

- **Characterization** – It is very easy to implement this suggestion, but its importance in the event of a future challenge cannot be underestimated. All board members and company representatives involved in the financing should avoid negatively characterizing the down round as a "washout" or "cramdown" in any type of written or oral communications. This type of language could be referenced by a future plaintiff to show that there was a lack of good faith and an intent to dilute the shareholders or eliminate existing management.

- **Shareholder Disclosure** – Finally, the board should not forget to keep the minority shareholders informed. A lack of notice to the shareholders regarding the terms of the financing would seriously impair proof of the fair dealing aspect of the fairness test. The board should at least comply with any notice and reporting requirements present in the corporate charter, shareholder agreements or statutes, and attempt to provide the shareholders with this information at all stages of the financing

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Other Low Cost Options

While the first set of procedures represent the bare minimum a board should implement, the second set of measures described below are also fairly cost-effective and involve relatively little cost to the company. These next three measures are, however, alternatives that entail the active involvement of, or conciliation to, existing shareholders.

- **APPROVAL BY DISINTERESTED SHAREHOLDERS** – Even though approval of this group on its own would not be sufficient to validate the financing, it is still advisable for a board to gain the approval of the *disinterested* shareholders. Courts are reluctant to approve inside transactions that are simply approved by a majority of shareholders, because oftentimes the majority of shareholders are also interested parties. An approval by the remaining shareholders would demonstrate that a *true* majority of shareholders endorse the transaction. The caveat is that the shareholder approval must also be informed. A judge will not rely on a shareholder approval where the shareholders were not given full information about the nature of the transaction and the conflicting interests of the parties.

- **RIGHTS OFFERING** – To the extent that it is feasible, the company should consider offering the diluted shareholders a chance to participate in the financing. This will help the company establish an equal treatment of all shareholders, as well as afford the shareholders and opportunity to reduce their equity dilution. It is understandably difficult to do this, but even a limited offering, an equal offering to "accredited" shareholders, or a chance for shareholders to participate after the initial closing with the lead investor, would serve to establish some increased level of good faith and fair dealing.

- **IMPROVED TERMS** – As with the rights offering, other improved terms of employment or employee benefits will only help to buttress a board's claim of fair dealing. For example, offering additional options or warrants, lowering liquidation preferences, including anti-dilution provisions and adding other such features demonstrates a valuable "pro-company" stance in the face of a dilutive financing.

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Desirable But Costly Options

These next three procedures are undoubtedly some of the most effective at demonstrating the fairness of the transaction. This effectiveness comes at a cost; these are also the priciest alternatives. If a company can afford these options, they are highly recommended. The reality, however, is that most companies conducting inside down rounds are typically short on time and money, both of which are essential for most of these options. One principle runs throughout these suggestions: the participation of any disinterested third-party individual or committee in the evaluation of the financing is desirable.

- **Fairness Opinion/Independent Evaluation** – The board should consider hiring an independent third-party, such as a financial advisor, to render a fairness opinion or conduct an independent appraisal of the financing. In Delaware, this action is recommended by the courts and creates a rebuttable presumption of fairness in favor of the financing company. The independent evaluator will essentially perform the same functions noted above: perform market checks, explore alternatives to financing and provide a basis for the valuation and terms of the financing. Independent fairness opinions are highly regarded as reliable sources, but they are often extremely expensive and time consuming. A less costly (but still time consuming) alternative is to appoint a "special committee" of disinterested board members and other equity holders who will be affected by the financing to sit as an "in-house" independent evaluator. This is a fine option, but as noted above, it is exceedingly difficult in inside down rounds to identify a truly disinterested director.

- **Outside Investor Counsel** –A company may suggest to the existing investor(s) the possibility of hiring an additional outside counsel for purposes of the particular financing. This counsel would serve virtually the same purpose as the independent evaluator, and could offer unbiased advice regarding all issues connected with the transaction.

- **Insurance** – While this option does not speak directly to establishing the fairness of the transaction, obtaining or increasing D&O insurance is a wise idea for any company contemplating an inside down round where there is a possibility of future liability.

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Innovative Alternative

This final alternative is an innovative idea presented as a way to satisfy, or even circumvent, a challenge to the fiduciary duty aspect of an inside down round. While this is an appealing idea in theory, it has yet to be tested in practical terms, and is merely advanced here as a possibility to be considered.

- **NEXT ROUND PRICING** – Next round pricing is typically used in the early stages of financing, where parties disagree significantly on the valuation, or valuation is difficult because of the immaturity of the company. The investors issue a bridge note that is later converted at a price that is a function of the pre-money valuation of the following round. Employing this strategy in the context of a down round would suspend liability for breach of fiduciary duty because the valuation technically does not yet exist, as it is deferred until the subsequent round. This appears to eliminate any violation of duty. The downside is that investors, both outside and existing, who are willing to invest in a severe type of down round, such as a "washout," are depending on the stock to be rendered almost worthless. The motivation behind this type of financing is often to gain a "fresh start." If, as in *Alantec*, the company introduces a new product line or takes some other course of action that causes their earnings to soar, the deferred valuation will be surprisingly high The additional uncertainty and risk involved understandably gives investors reservations about using this type of strategy in the field, but it is an alternative that has been suggested.

CONCLUSION

Companies who are contemplating an inside down round financing face a significant risk of a future challenge to the validity, or "entire fairness," of the transaction. There is very little judicial guidance in this area, and companies are counseled to employ as many of the above listed strategies as economically possible when contemplating or conducting an inside down round. While hiring an independent third-party to perform a fairness evaluation is often the most recommended procedure, it is frequently too time consuming and costly for the types of companies that typically conduct these types of rounds. At the very least, companies should keep detailed and accurate records of all board deliberations and discussions regarding the financing, justify the valuation through a market check comparison and clearly disclose the terms and conditions of the financing to all shareholders.

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[1] *See* Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) ("The director's fiduciary duty … has been characterized by this court as a triad: due care, good faith and loyalty …." (citing Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939))).

[2] *See* Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

[3] DEL. CODE ANN. tit. 8, § 144 (2000).

[4] *Id.* § 144(a)(1) – (a)(3) (emphasis added).

[5] "It is a well settled principle of Delaware-law that where directors stand on both sides of a transaction, they have the burden of establishing its entire fairness …, [which] has two components: fair dealing and fair price." Union Illinois v. Korte (Del. Ch. Sept. 14, 2001), *available at* 2001 WL 1526303, at *4 to *5 (internal citations omitted).

[6] *Weinberger*, 457 A.2d at 711.

[7] *Id*. at 710.

[8] *See* Kahn v. Lynch Communication Sys., Inc., 638 A.2d. 1110, 1117 (Del. 1994) (discussing the entire fairness standard with respect to minority shareholder challenge to majority shareholder actions).

[9] *See, e.g., Weinberger,* 457 A.2d at 710-14 (addressing in the context of a merger). While there are no reported cases that address the entire fairness standard in the context of inside down rounds, the issue was set to be litigated in the *Alantec* case. *Alantec*, however, settled before trial. William M. Kushner, *Down Round Financing: Stockholders Whose Interest Undergo Dilution May Make Claims for Fraud, Breach of Duty*, 21 NO. 11 LJN'S EQUIP. LEASING NEWSL. 4 (Nov. 2002).

[10] Alex Grove, *Washouts Take a Bath: A recent court case raises some difficult questions for venture capitalists and struggling startups*, RED HERRING, Dec. 1999, *available at* http://www.redherring.com/mag/issue43S/bath.html (subscription required)

[11] No. CV-739278 (Santa Clara Sup. Ct. filed Mar. 23, 1994).

[12] The three investment funds that financed the Series B round were Accel Partners, Mayfield Fund, and T.A. Associates.

[13] After these two rounds, the price of the issued stock was set at $.005 per share. *See* Jose M. Padilla, *What's Wrong with a Wash-Out?: Fiduciary Duties of the Venture Capitalist Investor in a Wash-Out Financing*, 1 HOUS. BUS. & TAX L.J. 269, 277 (2001).

[14] The case settled after eighteen days of trial testimony. *Id*. at 278.

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[15] No. Civ.A. 19719 (Del. Ch. July 15, 2002), *available at* 2002 WL 1732423. The background facts in this section are taken primarily from public information regarding the settlement and from the plaintiffs' initial complaint. *See Kushner, supra* note 8.

[16] CIBC is based in Toronto, Canada. The financing at issue in this case, however, takes place through a subsidiary, CIBC Delaware Holdings, Inc.

[17] *Benchmark*, 2002 WL 1732423 at *1 (quoting Juniper's Amended Certificate of Incorporation).

[18] *Id.*

[19] *Id.*

[20] The Committee consisted of three members. Two members were appointed by the Series A preferred and Series B preferred stockholders, and one member appointed by CIBC. The CIBC-appointed member was allegedly a friend and colleague of one of the defendant board members.

[21] The new certificate of incorporation that resulted from the merger still included all of the same protective provisions for the newly converted Series A preferred and Series B preferred stock that existed in the previous certificate of incorporation. The newly converted stock, on the other hand, gave Benchmark substantially diminished rights. For example, Benchmarks liquidation preference under the newly converted stock was $15 million, as compared to the $115 million preference under the previous stock. Also, the dividend payable on Benchmark's stock was reduced from $0.11 per share to $0.03 per share. *See Benchmark*, 2002 WL 1732423, at *5 n. 20.

[22] 715 A.2d 843 (Del. 1998).

[23] Bradley R. Aronstam et al., *Delaware's Going-Private Dilemma: Fostering Protections for Minority Shareholders in the Wake of Siliconix and Unocol Exploration*, 58 BUS. LAW. 517, 523 (2003).

[24] *Id.*

[25] The court declined to grant a preliminary injunction to prevent the investors from following through with the merger. In deciding the case, the court looked to (1) the reasonable probability of the success of Benchmark's claims; (2) irreparable harm if not granted; and (3) balancing of the equities. The court did not specifically decide that the investor's actions in *Benchmark* were consistent with the "entire fairness" standard; it simply concluded that Benchmark's argument regarding the lack of merger language in the charter was questionable, and that the harm that would be suffered by the investors if the injunction was granted outweighed the harm that Benchmark would suffer if it was denied. Indeed, the presiding judge specifically notes at the end of the opinion that the overall issue is "not easily dismissed … Nonetheless, as I balance the

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various well-known factors [regarding the injunction] as I must, I conclude that Benchmark has failed to justify a preliminary injunction." *Benchmark*, 2002 WL 1732423 at *16.

[26] The third member was in fact a friend and colleague of the main defendant and board member, Richard Vague.

[27] *Benchmark*, 2002 WL 1732423 at *4 n.14

[28] *See supra* note 9.

[29] *See* Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).