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Client Alert

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May 6, 2013

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Delaware Court Opens the Door to Private Dilution Claims Against Venture Capital Firms

The Delaware Court of Chancery's recent opinion in *Carsanaro v. Bloodhound Technologies* is a wake-up call to venture capital firms. In a nearly 40 page opinion, Vice Chancellor Laster held that VCs are not necessarily immune to private litigation from shareholders who claim unfair dilution from down round financing transactions, even when the VCs are not controlling shareholders. Under *Bloodhound*, early investors have standing to pursue direct litigation to challenge dilutive stock issuances when the transaction is not approved by a majority of disinterested and independent directors.

Prior to *Bloodhound*, unless a controlling shareholder stood on both sides of the stock issuance, shareholders could pursue only derivative litigation to challenge a dilutive stock transaction—the lawsuit would be brought on behalf of the company and only if the shareholder could establish demand futility. As a practical matter, the absence of a direct financial incentive to pursue litigation and the procedural hurdles associated with derivative litigation made lawsuits arising out of dilutive stock transactions relatively rare. But *Bloodhound* opens the door to direct lawsuits by early investors when a majority of directors who approve the dilutive transaction are beholden to participating investors—which is not unusual in venture capital financing transactions.

Venture capital firms should anticipate the possibility of more litigation from early investors who claim they were unfairly diluted by down round stock transactions. Although the alleged structure of the financing transactions in *Bloodhound* may be particularly egregious, venture capital firms can take cues from the opinion to structure future deals to minimize the risk of private shareholder litigation. This Alert endeavors to summarize the details of those transactions, explain why the court extended prior Delaware holdings to find standing in light of the transactions, and suggest ways VCs can minimize their risk of future liability.

I. Plaintiffs allege that the VCs unfairly diluted their holdings.

Five of Bloodhound's original software developers, including its founder, sued the company's board of directors and the VC funds they represent for several rounds of alleged self-interested and highly dilutive fundraising.

Plaintiffs allege that in approving the financing, defendants breached their fiduciary duties to plaintiffs, violated Delaware General Corporation Law (DGCL), and committed constructive fraud.

Plaintiff Joseph A. Carsanaro saw an opportunity to capitalize on the growth of healthcare claims processing and submission via the internet in the mid-1990s. After spending nearly two years testing a web-based application for healthcare claims, Carsanaro hired additional software developers (who are also plaintiffs to the suit) and founded Bloodhound in 1998. The company was initially financed through funds raised from Carsanaro's friends and family.

In 1999 Bloodhound released its first web-based application and sought venture capital funding. In the next year it conducted Series A and Series B rounds of financing, issuing preferred stock to various venture capital funds that invested in the company.

Plaintiffs challenged the financing rounds that followed the Series A and B rounds, as well as the alleged "takeover" by the venture capitalist investors. First, plaintiffs allege that the two board members appointed by the VC investors convinced Carsanaro to step down as CEO. Second, the VC board members convinced the board to conduct a Series C round, issuing shares of Series C convertible preferred stock. Plaintiffs alleged they were not kept informed about the terms of the Series C financing. Third, the VC board members increased the size of the board from five to six members and asked Carsanaro and the other remaining member of the founding team to resign from the board.

Following the alleged takeover, the newly-comprised board conducted two additional financing rounds, Series D and E, in which the board members' affiliated venture capital funds were the only participants and unilaterally set the terms of the financing, which the plaintiffs allege unfairly diluted their holdings. Prior to the Series E round, the board resolved to effectuate a 10-for-1 reverse stock split. While the stock split required the written consent of four stockholding members of management, including one of the plaintiffs, consent was not solicited from the remaining plaintiff stockholders. The Series E charter did not adjust the conversion prices of the Series A, B, or C preferred shares to account for the reverse split, contrary to the board resolution authorizing the Series E financing, and making the conversion rights of the Series E shares substantially more valuable than shares issued in prior rounds. The company entered into separate agreements with holders of Series D and E preferred shares to issue them additional shares to account for the dilution, but did not do the same with the Series A, B, or C holders. The board subsequently approved four more issuances of Series E preferred shares on the same terms established in November 2002, all purchased by board members and their affiliated funds. The board did not give notice of the Series E financing to the other common stockholders.

In April 2011, Verisk Health Inc. acquired Bloodhound for $82.5 million. Contemporaneously, the board approved management incentive awards totaling $15 million. Of the purchase price, common stockholders received only $99,625 of the proceeds, with three of the five members of the founding team receiving less than $1,000 each. The founding team alleged that they first learned of the acquisition in late April 2011 (after it had occurred) and were allegedly "shocked" to discover that their aggregate ownership on an as-converted basis had been diluted to less than 1%. After perfecting their appraisal rights and obtaining certain documents, they sued in the Delaware Court of Chancery.

II. The Delaware Court of Chancery extended prior case law, holding that plaintiffs can pursue their claims directly rather than derivatively on behalf of Bloodhound, and that plaintiffs sufficiently stated their claims.

In moving to dismiss the complaint, defendants argued (among other things) that the plaintiffs did not have standing to pursue their claims. Typically, shareholders can bring claims based on the diminution in the value of their shares only derivatively on behalf of the company, and not directly on behalf of themselves personally. The reasoning underlying this rule, as explained in the Delaware Supreme Court case *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004), is that the company is the party truly injured by the alleged acts of the board of directors. Any injury to shareholders is due to the injury to the company, and any recovery in the suit is properly due to the company. The defendants in *Bloodhound* argued that plaintiffs' claims fell under the *Tooley* holding. They further argued that the Verisk Health acquisition of Bloodhound extinguished plaintiffs' standing to bring the derivative claims because plaintiffs were no longer shareholders of Bloodhound and therefore could not sue on behalf of the company.

Vice Chancellor Laster held that, while in some cases dilutive stock issuances are derivative, in the *Bloodhound* case they were direct. In doing so, he extended the line of authority based on the Delaware Supreme Court case *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006), and also recognized the California Supreme Court case *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93 (Cal. 1969), which held that minority shareholders can sue majority shareholders directly for actions that unfairly devalue the minority's shares. He concluded that standing to pursue a direct action also exists when the board that effectuated the dilutive transaction lacked a disinterested and independent majority. Central to the holding was that, while there was no single majority shareholder, plaintiffs sufficiently alleged that the majority of Bloodhound directors were either representatives of the VC firms receiving additional shares in the funding rounds or personally received shares, collectively forming a "control group" that directed the company's capital raising activities in a self-interested way. The effect of the additional stock issuances was felt at the stockholder level when economic value and voting power was transferred from the existing stockholders to the ones receiving the newly-issued stock. The existing stockholders, therefore, were harmed directly. Finally, since the ability to sue directly does not depend on stockholder status, the acquisition made no difference to their standing.

Not only did the court hold that plaintiffs had standing to sue, but also that their complaint alleged sufficient facts to state a claim, and thus it allowed the case to continue into discovery. Typically, alleged breach of fiduciary duty claims are reviewed under the so-called "business judgment rule." This rule presumes that in making a business decision, a board of directors acts on an informed basis, in good faith, and with the honest belief that the decision is in the best interest of the company. When the majority of directors lack independence, however, the presumption is overcome. And if a plaintiff can show actual self-interest in the transaction, the burden shifts to the defendants to show that the transaction was entirely fair to the shareholders.

In *Bloodhound*, the court held that plaintiffs alleged sufficient facts to overcome the business judgment rule and established that the board's actions were self-interested and unfair. In the later rounds of financing, the VC firms' participation caused their appointed directors to lack independence, overcoming the business judgment rule. The court further found that plaintiffs sufficiently alleged that the following board actions were unfair to the common shareholders: (1) the unilateral setting of financing terms without any market canvass or third-party input, (2) acceptance of VC funding proposals without an effort to explore alternative financing, and (3) failure to modify or update the terms of the follow-on financing to account for Bloodhound's improving financial condition. While the plaintiffs must eventually put forth sufficient evidence to prove these allegations, the court held that they were sufficient at the pleading stage to allow the lawsuit to continue.

III. Lessons learned from *Bloodhound* to reduce the risk of shareholder suits.

Whether *Bloodhound* will result in a wave of private litigation against VC firms by disgruntled founding shareholders is yet to be seen. But VC firms are attractive, deep-pocket targets for the plaintiffs' bar, and the *Bloodhound* opinion opens the door to direct litigation challenging dilutive stock transactions. There are several lessons for VC firms in the *Bloodhound* opinion, many of which are already commonly practiced, to preserve the protections of the business judgment rule in future deals and to minimize future litigation risks.

First, financing transactions involving VC firms affiliated with board members should be fully disclosed and approved by a majority of disinterested and independent directors or by independent stockholders whenever possible, as suggested by DGCL § 144. Such approval will shift the burden of proof of unfairness back to the plaintiff should litigation arise. Financing transactions with third-party investors who do not control the board should not trigger the conflict issues present in *Bloodhound*.

Second, if it is not possible or practical to have a majority of disinterested and independent directors or stockholders approve the financing transactions, then the board should take steps to ensure that the negotiation process and price is fair to the company and to existing shareholders. The board should consider: (1) appointing a committee of independent and disinterested directors to negotiate the terms; (2) performing a market check to obtain and compare competing offers, and documenting the steps taken and competing offers received in meeting minutes; (3) obtaining an unbiased, third-party valuation of the company or, if practical, a written fairness opinion from an independent and reputable source.

Finally, the board should provide full and fair disclosure of dilutive stock transactions to existing shareholders under DGCL § 228(e). Although the dilutive stock transactions in *Bloodhound* occurred as many as 10 years before plaintiffs filed suit, the court rejected defendants' argument that the claims were time barred because the company did not disclose the terms of the transactions to shareholders. Had the board put shareholders on proper notice of each of the financing transactions, the plaintiffs would have had to file their action within three years of each transaction, many years before the multi-million dollar acquisition made the potential damages skyrocket.