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Delaware Court Applies *Revlon* standard to Convertible Debt Transaction

In *Binks v. DSL.net, Inc., et al.*, a recent unreported decision, the Delaware Chancery Court granted DSL.net, Inc.'s (DSL) motion to dismiss all claims brought by Charles M. Binks for failure to state a claim upon which relief could be granted and loss of standing to sue derivatively as a result of the merger between DSL.net, Inc. (DSL) and MegaPath, Inc. Binks, a former minority stockholder of DSL, asserted a wide range of claims in relation to a 2006 financing transaction between DSL and MegaPath. Bink's claimed, among other things, (i) that DSL's directors breached their *Revlon* duties by failing to obtain the best price reasonably available in a change in control transaction and diluting stockholder equity by approving and executing the MegaPath financing transaction; (ii) that the transaction should be subject to an entire fairness review as a result of a conspiracy between Megapath and VantagePoint Venture Partners, L.P., which was at certain times the controlling shareholder of DSL; and (iii) that the DSL board and MegaPath committed corporate waste.

Background

Despite receiving significant financing in 2005 from DunKnight Telecom, LLC, which allowed DSL to repurchase stock, warrants and debt held by VantagePoint and other investors (the "DunKnight Transaction"), DSL was in severe financial trouble in 2006. After engaging a financial advisory firm and exploring its options for a period of six-months, the DSL board determined that the only two options available to the company were either filing for bankruptcy or entering into a financing transaction with MegaPath. The Board chose to enter into the financing transaction with MegaPath, which consisted of issuing to MegaPath convertible notes, representing on an as-converted basis more than 90% of the common stock of DSL, in exchange for a \$13M loan from MegaPath. Six months after the financing transaction closed, MegaPath exercised the conversion options in its notes and effected a short form merger to eliminate the minority stockholders.

Breach of Fiduciary Duties

The plaintiff argued that, in light of the subsequent merger between MegaPath and DSL, the DSL board's approval of the financing transaction with MegaPath was subject to the *Revlon* standard of review. DSL contended that a debt placement occurring more than six months prior to a merger, without any express guarantee that such merger would occur, should be entitled to the protections of the business judgment rule. The Court disagreed with DSL, pointing out that in determining if a transaction constitutes a change of control for *Revlon* purposes "the specific circumstances surrounding the transaction" must be considered. The Court read Bink's complaint to allege that the merger was part of a broader change of control transaction and "was an inevitable and foreseeable consequence" of issuing the convertible notes to

MegaPath. Relying heavily on *Equity-Linked Investors L.P. v. Adams*, 705 A.2d 1040, 1055 (Del. Ch. 1997) in which the Court held that *Revlon* duties may arise when a board approves a transaction that has a change of control effect and where “corporate action plays a necessary part in the forming of a control block where one did not previously exist”, the Court assumed, without deciding, that the MegaPath transaction was subject to review under *Revlon*.

The Court held that the DSL board did not breach its duties under *Revlon* since the majority of directors were independent and disinterested with respect to the financing transaction and were well informed by independent financial advisors. The Court held that simply choosing the financing transaction over bankruptcy was not sufficient grounds to base a claim that the board “utterly failed” to obtain the best price for shareholders. Rather, the Court found that the DSL board’s conclusion that the financing transaction was preferable to bankruptcy was well within its business judgment. Once again relying on *Equity-Linked Investors*, the Court affirmed that in circumstances where maximizing the present value of a company’s equity is not obvious, such as choosing between financing and bankruptcy instead of two competing cash transactions, the law simply requires that directors “exercise independent, good faith and attentive judgment” with respect to the information necessary to make the decision and with respect to the decision itself.

Entire Fairness

Bink’s also alleged that VantagePoint and MegaPath conspired to purchase DSL “for fractions of a penny” by employing the DunKnight Transaction, the financing transaction and the merger as part of a predatory and self-dealing transaction. Bink’s claimed that as the result of the alleged conspiracy between VantagePoint and MegaPath, MegaPath assumed the fiduciary duties owed by VantagePoint, as a controlling stockholder, to DSL’s stockholders and for that reason the transactions should be held to an entire fairness review. The Court found that the entire fairness standard did not apply because MegaPath was not a controlling shareholder at the time of the contested transaction, and that standard would only apply to “an actual-not a potential-controlling shareholder”.

Corporate Waste

The Court dismissed Bink’s claim that DSL’s directors committed corporate waste in issuing over 2.6 million shares to MegaPath for “no consideration” for two reasons: (i) since the directors met their obligations under *Revlon* with respect to the transaction, a corporate waste claim pled on the same facts was precluded; and (ii) as a derivative claim, it was extinguished by the merger.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.