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Re: Amazon.com, Inc. v. Hoffman, et al.
C.A. No. 2239-VCN
Date Submitted: September 12, 2008

Dear Counsel:

Plaintiff Amazon.com, Inc. ("Amazon") is the only holder of Series A preferred shares of Defendant Basis Technology Corporation ("Basis"), a Delaware corporation.[1] Amazon acquired those shares in 1999 in accordance with the Series A Preferred Stock Purchase Agreement (the "Agreement")[2] which incorporated and implemented the Certificate of Designation (the "Designation"). By Section C(5)(c)

[1] The facts are taken from the well-pled allegations of Amazon's Verified Amended Complaint. As will be seen, Amazon is no longer the owner of preferred shares, but the import of that development must await a review of the allegations of the governing complaint.
[2] Compl. Ex. A.

of the Designation, Amazon had the right to convert its preferred shares into Basis common stock at a price of $2.72 per share; in 2001, the conversion rate was adjusted to $1.36 per share.

In order to protect its equity position in Basis, Amazon negotiated an anti-dilution provision. By Section C(5)(d)(i) of the Designation and in accordance with Article IV, Sections (B)(4)(a) & (B)(4)(d)(i) of Basis's Amended and Restated Certificate of Incorporation (the "Charter"),[3] the conversion price would be adjusted in Amazon's favor if Basis issued any new stock at a price (or conversion equivalent) less than $1.36 per common share.

* * *

Amazon challenges two transactions in which Basis issued new preferred stock, convertible into common stock, for $1.39 per share, a price that Amazon concedes was above fair value. Amazon contends that the price was set to allow Basis to avoid the Amazon-protective anti-dilution feature tied to the $1.36 per share conversion price. In short, it alleges that the individual defendants—the directors of Basis—breached their fiduciary duties by engaging in a concerted effort

[3] Compl. Ex. B.

to avoid triggering Amazon's anti-dilution rights. In addition, Amazon alleges that the defendant directors issued the additional shares without due consideration of the potential impact on Amazon's interests. This conduct, Amazon argues, also breached the Agreement's and the Charter's implied covenant of good faith and fair dealing. Amazon seeks an award of damages.[4]

* * *

Basis, in 2004 and in 2006, issued to In-Q-Tel its Series B Preferred shares at a price only three cents above the anti-dilution trigger.[5] First, in 2004, Basis issued 466,827 shares of Series B Preferred stock to In-Q-Tel[6] as part of a larger transaction that included a payment by In-Q-Tel of $150,000 for "software and licensing rights to certain early stage technology"[7] (the "2004 Transaction"). The Series B Preferred shares were issued for $1.39 per share and could be converted into common shares on a one-to-one ratio. Second, in 2006, In-Q-Tel acquired additional Series B Preferred shares, this time 804,352 of them, again for $1.39 per

[4] Amazon has not specifically explained how it was damaged other than a general allegation that "[s]uch issuances benefited the holders of common stock to the detriment of Amazon." Compl. ¶¶ 14, 18, 35. It has not sought an award of additional shares or an adjustment of the effective conversion price.
[5] In 2001, shares were issued to In-Q-Tel at the same price. That transaction is not challenged in this proceeding.
[6] Shares were issued to In-Q-Tel, Inc. and to In-Q-Tel Employee Fund, LLC. Compl. ¶¶ 8(iv), 15.
[7] *Id.* ¶ 15.

share (the "2006 Transaction").[8] Amazon, in these proceedings, challenges both the 2004 Transaction and the 2006 Transaction.

The individual defendants comprise Basis's board of directors. Carl W. Hoffman, Basis's chairman and chief executive officer, controls approximately 85% of its common stock. Steven Cohen, who owns roughly 11% of Basis's common stock, is executive vice president and vice president for product development.[9] Amazon's Amended Complaint does not allege that either Hoffman or Cohen has any special relationship with In-Q-Tel.

* * *

Before the Court is Defendants' motion, under Court of Chancery Rule 12(b)(6), to dismiss the Verified Amended Complaint for failure to state a claim upon which relief can be granted. A motion to dismiss for failure to state a claim requires the Court to assume the truth of all well-pled allegations of the Complaint and to confer upon the plaintiff the benefit of all reasonable inferences

[8] Amazon and Basis were involved in litigation, begun in 2003, in Massachusetts (the "Massachusetts Litigation") over a dispute involving services provided by Basis to Amazon. *Basis Tech. Corp. v. Amazon.com, Inc.*, 878 N.E.2d 952 (Mass. App. 2008), *further appellate review denied*, 881 N.E.2d 1141 (Mass. 2008) (TABLE). As part of the settlement of that action, as later enforced by the courts of Massachusetts, Amazon converted its Basis preferred shares into common shares.

[9] Amazon does not challenge the independence and disinterestedness of the other two defendant directors.

that can be drawn from such allegations.[10] Dismissal is inappropriate unless "it appears with a reasonable certainty that the plaintiff would not be entitled to the relief sought under any reasonable set of facts properly supported by the complaint."[11]

* * *

Amazon sponsors an unusual argument: Basis's board of directors issued stock at too high of a price. This is not a claim sounding in waste; it is not the typical allegation of a sweetheart deal resulting in the cheap sale of newly issued stock to the detriment of other shareholders. Instead, Amazon tenders a more complicated argument. It contends that the issuance of Basis preferred stock to In-Q-Tel must be assessed within the context of a multi-faceted overall business relationship that involved both an equity investment by In-Q-Tel and a sale by Basis to In-Q-Tel of software licensing rights. Perhaps the concern is that although the stock was priced above $1.36 per share, the software licensing rights were sold too cheaply. In other words, part of the licensing payments were moved to payment for

[10] *See, e.g.*, *Solomon v. Pathe Commc'ns Corp.*, 672 A.2d 35, 38 (Del. 1996).
[11] *FS Parallel Fund L.P. v. Ergen*, 2004 WL 3048751, at *2 (Del. Ch. Nov. 1, 2004).

the stock, giving the appearance that the stock was issued for more than the parties valued it themselves.[12]

Basis could not issue stock at less than $1.36 per share without triggering the anti-dilutive provisions of the Agreement. It satisfied the terms of the Agreement—the stock was issued above the trigger price. The parties had negotiated this trigger; the Agreement does not provide for any anti-dilution rights in the event that stock is issued for $1.36 per share or above.

Amazon alleges that the $1.39 per share price was established without sufficient process. It asserts that the defendant directors met only once with respect to the various sales but, nevertheless, came to the exact same price even though, one would assume, the economics of the industry and the fiscal situation of Basis must have changed with time. Documents produced by Basis in response to Amazon's inspection of Basis's books and records under 8 *Del. C.* § 220 fail to reveal any effort by the directors to inform themselves of the value (or proper issue price) of Basis stock. Legal and financial advisors did not play an active role in arriving at

[12] Such concerns may be real; the Complaint does not allege, however, any cross-adjustment of equity price and product sale price, nefarious or otherwise. Instead, the Complaint, at paragraph 15, recites that "[i]n order to facilitate its relationship with In-Q-Tel, Basis structured the 2004 Transaction 'as a hybrid involving software licensing and equity investment.'"

the issue price. Amazon also complains that no specific consideration was given to the consequences of the stock issuance on the rights of preferred shareholders. These omissions, Amazon reasons, constitute a breach of the duties of loyalty and care owed by the defendant directors.[13]

In order to establish a breach of the duty of loyalty by an unconflicted board—one not tainted by self-interest or a lack of independence—Amazon must show that the directors "knowingly and completely failed to undertake their responsibilities . . . ."[14] The decision to issue stock at a price higher than its fair

[13] The 2004 Transaction may have suffered from some technical defects. Thus, in September 2006, the shares issued to In-Q-Tel in 2004 were exchanged for new shares. The exchange was authorized at a meeting of Basis's board in July 2006. At that meeting, the question of a fair price for the new (i.e., to be reissued) shares was addressed:

> [I]t was noted that [$1.39] is very reasonable and fair both by comparison to other companies similarly situated and based on the value of completing the commitment to In-Q-Tel under the March 2004 agreements . . . . It was noted that the Company has projected revenues for 2006 of under $10,000,000. It has issued and outstanding stock that on a converted basis is greater than 30 million common shares, and when taking into account issued and outstanding options is greater than 38 million common shares on a fully exercised and converted basis. Therefore, the proposed price of $1.39 per share is estimated to be not less than four times the gross revenues of the Company, and possibly closer to five or six times the gross revenues of the Company.

Compl. Ex. C (July 20, 2006, Board Minutes). Although Amazon argues that the approach is both flawed and superficial, it is not necessary to determine whether this after-the-fact consideration of fair value is either timely or sufficient.

[14] *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 243-44 (Del. 2009).

value—as conceded by Amazon[15]—simply does not satisfy that standard. Amazon has not explained how a director who authorized the sale of company stock for more than its fair value can be said to have acted disloyally or otherwise not in the best interests of the corporation and its various shareholders.

It is at least arguable that the absence of any real effort to determine an accurate and appropriate issuance price amounted to a violation of the defendant directors' duty of care. The Charter has a Section 102(b)(7) exculpatory clause to protect its directors against monetary liability for breach of the duty of care. In the absence of any basis to question their loyalty and good faith, they are protected by that charter provision.[16]

Amazon notes that Hoffman owns approximately 85% of Basis's common stock and then argues that Cohen, as executive vice president, is beholden to him for his livelihood and position with the company. Thus, according to Amazon, because the two directors comprise half of Basis's board, the actions of the board cannot be

[15] Amazon describes the price as "artificially inflated." Compl. ¶¶ 14, 18, 35, 38. Amazon also alleges: "In fact, because of the financial condition of [Basis] at the time these shares were purported to have been valued, the price should have been lower than $1.36 per share." *Id.* ¶ 53.
[16] Compl. Ex. B at Art. VIII. A § 102(b)(7) defense may be raised in the context of a motion to dismiss. *See, e.g.*, *Malpiede v. Townson*, 780 A.2d 1075, 1092 (Del. 2001).

considered the product of an independent and disinterested board.[17] Amazon alleges that as the controlling shareholder, Hoffman benefited from the issuance of stock to In-Q-Tel to the detriment of Amazon. If one accepts the Amended Complaint's allegations as sufficient to call into question Cohen's independence, then Amazon may be correct in arguing that the actions of the board were not independent of Hoffman's influence and control. What Amazon cannot explain, however, is how the two transactions resulting in the issuance of additional Series B Preferred shares somehow were transactions in which Hoffman was interested or from which he drew a benefit separate and distinct from his status of a common stockholder. There is no allegation of any relationship between Hoffman and In-Q-Tel. There is no allegation that Hoffman somehow specially benefited from the sale of stock to a third party at price above its fair market value. Amazon, however, does contend that Hoffman was motivated by his status as common stockholder to treat at lease one holder of preferred shares inequitably.

Thus, the debate comes down to question of whether some fiduciary duty owed directly (and apart from any duty owed to the common shareholders) to the

[17] Amazon is correct in its assertion that a four-member board with two conflicted members would not be considered an independent or disinterested board. *See, e.g., Beneville v. York*, 769 A.2d 80, 82 (Del. Ch. 2000).

preferred shareholders is implicated. Putting aside the authority that preferred stockholders have no fiduciary duty claims against directors that are not also fiduciary duty claims of common stockholders,[18] Series B Preferred stock (convertible into an equal number of common shares) was issued at a price greater than fair value.[19] The relationship between Amazon and Basis was defined specifically in the Agreement and included a specific understanding as to the minimum price at which stock would be issued. In the 2004 Transaction and the 2006 Transaction, the Agreement's negotiated protective provisions were not implicated. This is not a case where shares were issued for less than fair value and thus, might have had a dilutive effect (but that would have been a claim shared with the common shareholders).[20] In short, there was no breach of fiduciary duty and, to the extent that there might have been one in the nature of the duty of care, the exculpatory provision in the Charter precludes the pursuit of any such claim.

[18] *See, e.g., Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 597 (Del. Ch. 1984).
[19] The parties debate the proper interpretation of 8 *Del. C.* § 152, and whether it establishes a presumption of fair value that Amazon has failed to rebut. The Court does not need to enter this debate to resolve Defendants' motion to dismiss.
[20] As a preferred shareholder, Amazon's specific rights were ahead of those of holders of common stock. The issuance of common stock at a premium would, as a general matter, enhance the security of Amazon's investment.

* * *

Amazon next argues that the issuance of stock at a price of $1.39 per share violated the covenant of good faith and fair dealing implicit in all Delaware contracts.[21] The covenant of good faith applies when the "contract is truly silent with respect to the matter at hand, and only when the Court finds that the expectations of the parties were so fundamental that it is clear that they did not feel a need to negotiate about them."[22] The contractual requirements, set forth in the Designation, negotiated by Amazon, expressly and clearly define its rights with respect to this topic. If additional shares are issued at less than $1.36 per share, the anti-dilution provisions come into play. The Agreement, of course, does not expressly address what is to happen if shares are issued at a price equal to or greater than $1.36 per share, but the only plausible inference is that the parties considered the issue and reached agreement as to what price would trigger anti-dilution protection. The specific threshold to which Amazon and Basis agreed defines the

[21] Amazon has not brought an express breach of contract claim. Nor could it. The anti-dilution provision is unambiguous. It mandates an adjustment of the conversion price if stock is issued below the negotiated floor. Because shares were not issued at below the floor price, no claim of express breach could have survived a motion to dismiss. *See Schuss v. Penfield Partners, L.P.*, 2008 WL 2433842, at *6 (Del. Ch. June 13, 2008) ("Under Delaware law, the interpretation of a contract is a question of law, and a motion to dismiss is a proper vehicle to determine the meaning of contract language.").

[22] *Allied Capital Corp. v. GC-Sun Holdings, L.P.*, 910 A.2d 1020, 1033 (Del. Ch. 2006).

scope of the negotiated agreement; it cannot be said that "the expectations of the parties [if shares of common stock were issued for $1.36 per share or more] were so fundamental that it is clear that they did not feel a need to negotiate about them."[23]

To the contrary, the parties' understanding was obvious as to their expectations with respect to issuance of shares at a price not less than $1.36 per share. Here, Amazon obtained the protection (i.e., the fruits of its bargain) for which it had negotiated. It sought and obtained anti-dilution protection from having shares issued below a certain price. That shares were issued above that price (and also above fair value) does not impair the shared objectives manifested in the Designation.[24] In summary, the Amended Complaint does not state a claim for breach of the covenant of good faith and fair dealing.[25]

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[23] *Id.*

[24] Another way of characterizing Amazon's complaint is that the defendant directors were motivated by a desire to circumvent the anti-dilution provisions of the Agreement. That is, the price was set not only without adequate process, but also with the specific purpose of avoiding the rights conferred on Amazon as the holder of Series A Preferred shares. Amazon attempts to blend its contractual rights with whatever fiduciary protections it may have. If one complies with the terms of the Agreement—as the director defendants did—there is no express breach of contract. Similarly, there was no breach of the duty of loyalty when the defendant directors authorized the issuance of shares for greater than fair value under these circumstances. In short, by combining independent contractual duties and fiduciary duties, Amazon cannot demonstrate a resulting and more powerful right. If nothing else, such a creative approach would run the risk of altering the carefully honed relationship among preferred shareholders and common shareholders.

[25] As confirmed by an appellate decision in the Massachusetts Litigation, issued after the briefing and argument of the pending motion to dismiss, Amazon's preferred shares of Basis have been converted to common stock. The Massachusetts trial court found in the decision that was affirmed

* * *

For the foregoing reasons, the Amended Complaint is dismissed. Amazon is granted leave to amend to assert any claim that it may have had as a common stockholder with respect to the 2006 Transaction.

IT IS SO ORDERED.

Very truly yours,

/s/ John W. Noble

JWN/cap
cc: Register in Chancery-K

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that, as of March 2005 (i.e., before the 2006 Transaction), events that required the conversion had occurred.

That raises the question of Amazon's standing to pursue, as a preferred stockholder, its claims arising under the 2006 Transaction. At the time of the 2006 Transaction, it still literally held preferred shares (suggesting standing to assert the individual claims asserted here). Conversely, the Massachusetts court concluded that those shares should have been converted to common stock before then (suggesting that Amazon does not have standing to assert the claims here). If as of 2006, Amazon had no right to hold preferred shares, and in the absence of an unjust result, which does not appear to be the case here, the absence of rightful ownership should preclude standing.

Thus, the Court also concludes that Amazon lacks standing to pursue any claim as a preferred stockholder with regard to the 2006 Transaction. The conclusion that Amazon cannot be treated as preferred stockholder with respect to the 2006 Transaction leads to the corollary conclusion that it should be treated as having already been a common stockholder as of the time of that transaction (which it would have been if it had properly converted its preferred shares when otherwise required). Accordingly, it would have had standing to assert its claims regarding the 2006 Transaction as a common stockholder. Because the Massachusetts court's conclusion that it should have converted its preferred shares before the 2006 Transaction came after the pending motion to dismiss was submitted and, thus, Amazon did not have the necessary information when it filed its answering brief in response to Basis's motion to dismiss, see Court of Chancery Rule 15(aaa), it will be given leave to file another amended complaint asserting any claim that might have had as a common stockholder with respect to the 2006 Transaction. Any such amendment shall be filed with 20 days of the date of this letter of opinion.