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OF THE
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Re: *Smollar v. Potarazu*
C.A. No. 10287-VCN
Date Submitted: October 20, 2015

Dear Counsel:

Plaintiff Marvin Smollar ("Smollar") brought this derivative action on behalf of Nominal Defendant VitalSpring Technologies, Inc. ("VitalSpring") against Defendant Sreedhar Potarazu ("Potarazu"), VitalSpring's Chief Executive Officer, in an effort to remedy a series of fundamental failures in corporate governance. This litigation was not easy, but Smollar was able to achieve much of, if not most of, the relief which he sought: a stockholder's meeting, two independent board

members, a special review committee, and VitalSpring's hiring of an independent auditor. The accomplishments were embodied in a settlement agreement, including a proposed award of fees to his counsel, that has been submitted to the Court for approval.[1]

The Settlement Agreement, however, also affords Smollar a unique and personal benefit: VitalSpring has committed to buy his VitalSpring stock at the price Smollar paid fifteen years ago--$473,153.64, or roughly $0.16 per share.[2] This opportunity, however, is not available to other VitalSpring stockholders because its stock is difficult to trade as a consequence of provisions in VitalSpring's stock purchase agreement and the federal securities laws. Indeed, counsel for Smollar and Potarazu evidently are not aware of any transactions involving VitalSpring stock in the past twelve months.

Other VitalSpring stockholders have objected to the settlement, and their principal concern is the personal deal that Smollar negotiated for himself, while at

[1] Stipulation and Agreement of Settlement, Compromise and Release (the "Settlement Agreement" or "Settlement Agmt.").
[2] Settlement Agmt. ¶ 3.

the same time serving as a fiduciary for VitalSpring and its remaining stockholders.[3]

Smollar points to several circumstances that may justify or ratify his conduct. First, it appears that VitalSpring's stockholders generally support the settlement even with Smollar's equity buy back. Second, the equity buy back, in essence, is merely a return of Smollar's original investment fifteen years ago. Third, Smollar asserts that the bulk of the settlement benefits had been obtained through his efforts (and those of his counsel) before the equity buy back was negotiated.[4] If the benefits had already been obtained, there was no illicit motivation for Smollar to reach an agreement. Fourth, the Special Review Committee, as part of its independent function, has recommended the settlement, including the equity buy back provision. Fifth, VitalSpring has indicated that Smollar's investment in VitalSpring is now worth more than he will be paid for it.

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[3] Objections to the settlement have been filed by Jeffrey Waters, Abraham Hannink, Marijke Smit-van Dam, Paul van Riel, Bill Britt, Ken Logue, Ray Rice, Rohit Kishore, Nand Kishore, Sharad Tak, and Ulrich Werner (collectively, the "Objectors"). Among the challenges lodged by the Objectors to the sufficiency of the proposed settlement are that it does not address that Potarazu allegedly has obtained improper personal benefits and that the potential for Potarazu's control of the company through removal of independent directors has not been addressed.

[4] *See* Settlement Agmt. ¶ 4. In addition, these benefits address the derivative claims that Smollar asserted. *But see supra* note 3.

Finally, now that VitalSpring's board has a majority of independent directors, its recommendation of the settlement should be respected as a matter of business judgment.[5]

The Court's task in assessing a proposed settlement agreement is to determine if it is fair and reasonable. Typically, that involves balancing the claims and their likelihood of success against the risks and costs of litigating to final resolution.[6] Ordinarily, the independence and lack of self-interest on the part of the representative plaintiff—either in a class action or in a derivative suit—will raise no debate. Class representatives and derivative plaintiffs "accept the obligation to negotiate on behalf of the class [or the corporation] and to fairly and adequately protect the interests of the class [or the corporation]."[7] Indeed,

> [i]t is not necessarily a violation of a class representative's duty of loyalty to the corporation on whose behalf a derivative action is brought, or its shareholders as a class, for such representative to negotiate a form of settlement transaction that treats the representative

[5] Potarazu, under the proposed settlement, would obtain a broad release from possible past transgressions, a release that extends far beyond the specific relief that Smollar sought.
[6] *See, e.g.*, *Polk v. Good*, 507 A.2d 531, 535 (Del. 1986).
[7] *In re Banyan Mortg. Inv. Fund S'holders Litig.*, 1997 WL 428584, at *4 (Del. Ch. July 23, 1997) (internal quotation marks omitted).

> party somewhat differently than other shareholders. Circumstances may warrant diverse treatment.[8]

Nonetheless, "[b]ecause an award of enhanced benefits to the class representatives raises a concern that the representatives have breached their duty of loyalty owed to the class, any award of disparate benefits will be closely scrutinized by the Court."[9]

Smollar relies upon *Lacos Land*, which approved a settlement through which the representative plaintiffs' interest in the company would be purchased. There, the Court carefully examined the treatment and identified specific benefits flowing

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[8] *Lacos Land Co. v. Arden Gp., Inc.*, 1986 WL 14525, at *4 (Del. Ch. Dec. 24, 1986) (noting that a "special situation" justified paying certain shareholders a premium for their shares); *see also Amsellem v. Shopwell, Inc.*, 1979 WL 2704 (Del. Ch. Sept. 6, 1979) (small premium paid for plaintiffs' stock justified in part because of control factor); *Soin v. Thomas*, C.A. No. 5786 (Del. Ch. Apr. 12, 2011) (TRANSCRIPT) (approving purchase of bloc of stock as means of eliminating significant and detrimental internal dissension).

[9] *Banyan Mortg.*, 1997 WL 428584, at *4.

> Notwithstanding the fiduciary nature of the representative plaintiff's obligations, he or she may be tempted to extinguish the rights of absent class members in exchange for some advantage that is entirely personal to the plaintiff or his or her counsel. The central purpose of objective judicial review of voluntary dismissals and settlements in this context is to prevent such abuses.

Donald J. Wolfe, Jr. and Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery*, § 9.04[a] at 9-211 (2015) (footnote omitted).

to the corporation—and its stockholders—from that proposed purchase. As explained in detail in *Banyan*, the representative plaintiffs in *Lacos Land* had a ten percent interest in the company and there was a concern about a hostile takeover which could be facilitated by a sale to a third party of such a significant interest. Here, there is no corresponding benefit to VitalSpring for the purchase of Smollar's interest.

Moreover, its stock is illiquid and a "fair price" is unknown because of the lack of any recent trading. That Smollar would only recover his initial investment from many years ago does not demonstrate that the proposed purchase is fair. Smollar may be fortunate (who knows?) to recover his initial investment, and VitalSpring's assertion that he is taking less than his shares are worth is self-serving at best. Smollar appears to have used the influence emanating from his role as derivative plaintiff "for his personal benefit at the expense of . . . the corporation and its shareholders."[10] In short, "there is no indication here that purchase of [Smollar's] shares is motivated by a valid corporate purpose or is in

[10] *Lacos Land*, 1986 WL 14525, at *4.

any way justified by the unique position [the derivative plaintiff] occup[ies] as [a] shareholder[]."[11]

Perhaps the agreement to purchase Smollar's stock came at the end of the process of negotiating a settlement of this derivative action, but such a special benefit for Smollar fully undercuts any appearance that the settlement is fair and reasonable to the other stockholders who apparently remain locked into their equity positions with no certain or even probable exit strategy. Such self-dealing and grasping for a personal benefit drifts far from the conduct expected of a fiduciary.

That Smollar achieved what he intended for the benefit of VitalSpring is a factor supporting approval of the proposed settlement, but that benefit (and the others that might result from the proposed settlement) is significantly outweighed by the concerns raised by the unique benefits accruing solely to Smollar.[12]

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[11] *Banyan Mortg.*, 1997 WL 428584, at *6. The Court acknowledges that the relief sought by Smollar has, to a significant extent, been implemented. In *Banyan Mortgage*, uncertainty regarding the relief was a consideration counseling against approval of the settlement. *Id.* at *8.

[12] It is not the Objectors' (or the Court's) burden to demonstrate that the personal benefit accruing to Smollar tainted the settlement which he negotiated. The burden of demonstrating that a settlement is fair and reasonable rests with Smollar, and he cannot overcome the doubts generated by his special arrangement which carries no apparent benefit either to VitalSpring or to its stockholders.

Apparently, the Special Review Committee supports the proposed settlement because of the relief achieved by Smollar, but it does not appear to have properly assessed the potential consequences of Smollar's personal benefit and how that personal benefit calls into question the settlement's fairness and reasonableness.

With the conclusion that Smollar's personal benefit, as proposed in the Settlement Agreement, precludes approval of the settlement, the Court does not need to address any other issues regarding the settlement. The Court notes that some VitalSpring stockholders have moved to intervene and to be designated as the derivative plaintiffs. That motion will be addressed separately, after the interested parties have had the opportunity to express their views about the consequences of this decision.

IT IS SO ORDERED.

Very truly yours,

/s/ John W. Noble

JWN/cap
cc: Robert D. Goldberg, Esquire
Register in Chancery-K