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Delaware Court of Chancery Provides Guidance on Entire Fairness and Damages in Squeeze-Out Merger

In *In re Orchard Enters., Inc. S'holder Litig*., on cross-motions for summary judgment after a cash-out merger of the minority by a controlling stockholder, the Delaware Court of Chancery held that post-closing damages were available to stockholders as a remedy for disclosures in the merger proxy statement that were materially false or misleading, and such damages were available in the form of quasi-appraisal and rescissory damages. The court also held that even though the company employed a special committee and conditioned the merger on the approval of a majority of the minority stockholders, the business judgment rule would not apply to the court's review of the transaction, as those protective devices were not agreed to by the controlling stockholder in advance of commencing negotiations.

> "In my view, in an appropriate case Delaware law continues to recognize the possibility of a post-closing award of damages as a remedy for a breach of the fiduciary duty of disclosure."

BACKGROUND:

In November 2008, the controlling stockholder of The Orchard Enterprises, Inc. – a private equity fund named Dimensional Associates, LLC – informed Orchard's board of directors that it planned to contact third parties about buying Orchard or participating with Dimensional in taking Orchard private. Orchard had two classes of stock outstanding: common stock and convertible preferred stock. Dimensional owned 42% of the common stock and 99% of the preferred stock, for a combined total voting power of approximately 53%. Dimensional had also appointed a majority of the board pursuant to a stockholders agreement with Orchard. The preferred stock was functionally identical to the common stock except that it had a liquidation preference as well as a provision blocking change of control transactions. That blocking provision carved out exceptions for certain forms of transactions in which the liquidation preference was paid; however, this carve-out did not include a minority squeeze-out such as that proposed by Dimensional. As a result, although no liquidation preference was payable to the holders of the preferred stock in a squeeze-out, no such transaction could proceed without a waiver or amendment of the block provision.

In response to Dimensional's 2008 disclosure, Orchard's board of directors formed a special committee to oversee the Company's involvement. Dimensional contacted 53 parties; 11 signed non-disclosure agreements; and eight met with management; but no parties submitted formal proposals. As a result, Dimensional terminated the process and the board disbanded the special committee in April 2009.

Later, in the fall of 2009, Dimensional formally proposed a merger with Orchard to cash-out the minority stockholders. The price proposed by Dimensional valued the common stock giving effect to the full liquidation preference for the preferred stock, even though this liquidation preference was not payable in a squeeze-out merger. In response, Orchard's board of directors formed a second special committee with the exclusive power to negotiate and reject a transaction and to solicit interest from third parties. After

negotiations with Dimensional and another bidder offering a higher price for the common stock than Dimensional but unwilling to pay the full liquidation preference on the preferred stock, the special committee obtained a modest price increase from Dimensional and the right to conduct a go-shop. Although Orchard's CFO and outside consultants advised the special committee that the liquidation preference of the preferred stock would not be triggered in the cash-out merger with Dimensional, the special committee's financial advisor (purportedly at the direction of the special committee) valued the preferred stock (and therefore the price per share for the common stock in the Dimensional merger) using the full face amount of its liquidation preference instead of treating it as converted. After receiving the special committee's financial advisor's opinion that the price per share was fair to the minority stockholders, the special committee approved and recommended the transaction with Dimensional conditioned on approval of the transaction by a majority-of-the-minority stockholders.

The plaintiffs alleged that the directors who approved the merger breached their duty of disclosure by erroneously disclosing in the proxy statement that the liquidation preference would be triggered in the cash-out merger absent amendment, as well as through various other misleading and incomplete disclosures, including with respect to the relationship of the special committee chairman to Dimensional (after closing, the special committee chairman began work for Dimensional as a paid consultant). Furthermore, the parties disputed whether rescissory and quasi-appraisal damages were available as remedies and whether the court could award monetary damages for breach of a duty of disclosure after a merger closes.

ANALYSIS:

On the parties' cross-motions for summary judgment, the Court held that:

- *A post-closing award of damages was available for disclosure violations* – A previous Court of Chancery opinion, *In re Transkaryotic Therapies, Inc.*, had suggested that monetary damages may not be available for a breach of the duty of disclosure after a merger closes based on the rationale that after the stockholders have voted the harm cannot be remedied. The court held that the holding in *Transkaryotic* did not apply because the merger was not arms' length and there were triable issues of fact about the loyalty and good faith of the directors who authorized the disclosures. The court also held that for purposes of obtaining injunctive relief a stockholder will be irreparably harmed by a disclosure violation, but held that the court may still award monetary damages for breach of the duty of disclosure.

- *Post-closing damages could be in the form of quasi-appraisal damages or rescissory damages*

  - *Quasi-appraisal damages* – The court held that quasi-appraisal damages – as distinguished from a "quasi-appraisal procedure" designed to imitate statutory appraisal pursuant to DGCL Section 262 – were available to the plaintiffs. The court noted that "[q]uasi-appraisal damages serve as a monetary substitute for the proportionate share that the stockholders otherwise would have retained" and that quasi-appraisal damages are not limited to short form mergers.

    - The court's description of the availability of quasi-appraisal damages suggests that buyers of Delaware corporations, not just controlling stockholders

conducting squeeze-out mergers, may face post-closing, class-wide stockholder litigation on price, based solely on a breach of the fiduciary duty of disclosure, without any requirement for stockholders to opt-in to the class or to escrow a portion of the merger proceeds.

- *Rescissory damages* – Rescissory damages are the monetary equivalent of rescission, and if awarded, a defendant must disgorge the profits that the defendant achieved through the wrongful retention of a plaintiff's property. For post-merger rescissory damages, the court could award a plaintiff the value of the stock as of the date of the judgment, rather than the value as of the date of the merger. Here, the court held that rescissory damages may be appropriate if the merger was not entirely fair, one or more of the defendants committed a breach of the duty of loyalty, and the passage of time since the consummation of the merger did not preclude such an award.

- *Defendants were not entitled to business judgment review although a special committee negotiated the merger and the merger was conditioned on a majority-of-the-minority vote*–In a self-dealing transaction with a controlling stockholder, the applicable standard of review is entire fairness under Delaware law, but the court acknowledged the holding in *In re MFW S'holders Litig*., previously detailed here, stating that if the controlling stockholders had agreed up front, before any negotiations began, to proceed with the transaction only upon (i) the affirmative recommendation of an independent and disinterested special committee, and (ii) the affirmative vote of the majority of the minority stockholders, the defendant directors could have been entitled to business judgment review. However, because Dimensional did not agree up front, before any negotiations began, to any such conditions, the defendants had the burden at trial to prove that the transaction was entirely fair to the minority stockholders.

  - Under Delaware law, the use of either a special committee or a majority-of-the-minority vote can shift the burden to a plaintiff to prove that the transaction was unfair. The court held that the defendants were not entitled to a shift in the burden because (i) the proxy contained an incorrect statement so that the majority-of-the-minority vote could not have been fully informed, and (ii) the plaintiffs raised a factual dispute about (x) the independence of the special committee's chairman (whom the court called the special committee's "most influential figure") and (y) the fairness of the special committee's process. Despite this ruling, the court noted that use of the special committee and the majority-of-the-minority condition was not irrelevant, and if such protections were shown to be effective, they would "significantly influence" the court's determination of fairness and any potential remedy post-trial.

- *At the summary judgment stage, members of the special committee could not rely on an exculpation provision to have the claims against them dismissed* – The members of the special committee argued that they were entitled to summary judgment because at most their conduct could have amounted to a breach of the duty of care and Orchard's charter contained a provision, pursuant to DGCL 102(b)(7), exculpating the directors from any such breaches. Although members of the special committee were facially independent and disinterested, because the case involved a controlling stockholder and the merger was subject to the entire fairness standard of

review, the court held that it could not "summarily apply" the exculpation provision found in Orchard's charter to dismiss the claims against the special committee members.

  - The court held that where entire fairness applies, "the inherently interested nature of the transaction becomes inextricably intertwined with issues of loyalty"; therefore, a court cannot "hold as a matter of law that the factual basis for the claim *solely* implicates a violation of the duty of care." The court stated that only after a trial can a court determine whether a transaction was entirely fair and, if not, conduct a director-by-director analysis to determine who is exculpated from liability.

- *Compliance with the DGCL is paramount to eliminate the risk of* per se *disclosure violations* – The court held that the proxy statement erroneously stated that the liquidation preference would be triggered absent an amendment to the preferred stock certificate of designation and that because this inaccurate disclosure was contained in the proxy's notice provision required by the DGCL, the information was material *per se*. Accordingly, the court granted summary judgment in favor of the plaintiffs on this disclosure claim.

This decision raises a number of concerns regarding the possibility of post-merger damage awards for disclosure violations stemming from the breach of the duty of loyalty. Under DGCL 102(b)(7), a corporation can only exculpate directors from breaches of the duty of care, not from breaches of the duty of loyalty. Accordingly, even if the court decides initially not to enjoin a merger, directors can still face exposure to damages awards for inaccurate disclosures resulting from a breach of the duty of loyalty. Here, the court noted that quasi-appraisal damages could be the difference between the merger price of $2.05 per share and fair value of the corporation of $4.67 per share of common stock (as decided by then-Chancellor Strine in a previous appraisal decision in this matter). However, the parties to a merger agreement may be able to contractually agree to have the buyer, because it is a third-party, indemnify the former management and directors of the corporation being sold beyond the extent that the corporation would have been permitted under Delaware law. *Cf. Louisiana Mun. Police Emps.' Ret. Sys.* v. *Crawford*, 918 A.2d 1172, 1180 (Del. Ch. 2007).

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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