March 2014

In re Orchard Enterprises, Inc. Stockholder Litigation, C.A. No. 7840 (Del. Ch. Feb. 28, 2014)

Delaware Court of Chancery applies entire fairness review to a take-private merger with a controlling stockholder, despite approval by a special committee and a majority-of-the-minority, and holds that disclosure claims may give rise to post-closing money damages where the duty of loyalty is at issue.

Implications for our Clients

- To obtain business judgment review of a transaction with a controlling stockholder, it is critically important that procedural safeguards be established before substantive negotiations begin.
  - The controlling stockholder must agree at the outset to condition any transaction on approval by an independent special committee and the affirmative vote of a majority-of-the-minority of stockholders (these cannot be "deal points" to be negotiated).
  - Unless both of these procedural safeguards are implemented at the outset (even if both are implemented ultimately), the most the parties can obtain is entire fairness review with a shift in the burden of persuasion to the plaintiffs (business judgment review will not be available).
- Where entire fairness review applies, if there is "evidence of procedural and substantive unfairness," the exculpatory provision in a company's charter does not automatically protect even facially independent and disinterested special committee directors from potential liability for breach of the duty of loyalty; rather, each director must establish at trial that he or she is entitled to exculpation.

Evidence that the special committee chairman was not independent and acted in self-interest may require other facially independent and disinterested special committee members to defend their own conduct.

  - Special committee membership must be vetted carefully for potential conflicts of interest and lack of independence; if warranted, the special committee should be re-constituted.

Summary

The Delaware Court of Chancery largely denied summary judgment, thereby paving the way for trial on the merits of a take-private merger in which the common stockholders of The Orchard Enterprises Inc. were cashed out by Orchard's controlling stockholder. In a 90-page opinion, Vice Chancellor Laster found "evidence of substantive and procedural" unfairness in the process and price negotiated by a five-member special committee of directors and approved by holders of a majority-of-the-minority of the stock. The Court declined to apply business judgment review — or even shift the burden of persuasion under entire fairness review — in light of evidence that the structural protections outlined in *In re MFW* and *CNX Gas* may have failed to operate effectively to protect the interests of the minority stockholders.

The controlling stockholder, Dimensional Associates, LLC, held 53 percent of the voting power of Orchard through ownership of 42 percent of the common stock and 99 percent of the Series A convertible preferred stock. In October 2009, Dimensional made a proposal to buy out Orchard's minority stockholders for $1.68 per share in cash. Orchard's Board formed a five-member Special Committee, which was fully authorized to negotiate with Dimensional and potential third-party bidders and to hire independent legal and financial advisors. The Court of Chancery found evidence that the lead Special Committee director was neither independent nor disinterested in light of his long-standing relationships with family members of Dimensional's founder and his solicitation of a post-closing consulting engagement with Dimensional.

Valuation of Dimensional's Series A was a pivotal fact in the Court's analysis. The Special Committee's financial advisor preliminarily valued the common stock at $4.84, based on total equity value divided by the outstanding common stock — and assuming that the Series A would be converted to common stock and participate on a pro rata basis. This assumption effectively valued the Series A at about $7 million. Allegedly at the direction of the Special Committee,

- Directors considering special committee service should pay careful attention to the conflicts and independence of other possible committee members when considering whether to accept the committee appointment.

- Under entire fairness review, post-closing damages may be awarded if disclosures to stockholders in the solicitation of majority-of-the-minority approval contain material inaccuracies.
  - Further, even in arms-length third-party merger cases, post-closing damages may be available for materially misleading disclosures, subject to plaintiff's proof of reliance, causation and quantifiable damages.
  - This may lead to a reduction in pre-closing settlement of merger cases based on disclosures, or an increase in the cost of those settlements.
- The decision may be appealed eventually, and it is possible that certain of the holdings, particularly those concerning the availability of exculpation for facially conflict-free and independent directors and of money damages for disclosure claims post-closing, may be considered further.

Discussion

Delaware Court of Chancery precedent has established that the business judgment rule can apply to squeeze-out mergers by controlling stockholders where certain procedural safeguards are adopted. *In re CNX Gas Corporation Shareholders Litigation*, 4 A.3d 397 (Del. Ch. 2010), established that a transaction with a controlling stockholder may be subject to deferential business judgment review if the transaction is conditioned on approval by an independent special committee and by a majority of the minority stockholder vote. *In re MFW Shareholders Litigation*, 67 A.3d 496, 502 (Del. Ch. 2013), clarified that, to obtain business judgment review, the special committee must have authorization to negotiate and the controlling stockholder must agree to the dual independent approval process up front, before beginning negotiations.

In re Orchard reiterates this timing requirement when attempting to secure business judgment protection for a transaction with a controlling stockholder. Although the transaction ultimately was approved by a special committee vested with the authority to negotiate, and by a majority–of-the-minority stockholder vote, the Court of Chancery declined to apply the business judgment rule because the controller did not agree up-front to both of those protections (and, indeed, used the majority–of-the-minority approval as a deal point to reduce the purchase price). *In re Orchard* confirms (resolving a question left open by *CNX Gas* and *In re MFW*), however, that the burden of persuasion may be shifted from the defendants to the plaintiff under the entire fairness standard if a controller agrees to one but not both protections. While a shift in the burden of persuasion is commonly viewed as an inferior procedural benefit because it does not obviate a potentially costly and time-consuming post-closing trial on the merits, a shift in the burden still may be valuable to defendants by incentivizing plaintiffs to settle before trial.

the financial advisor later changed its approach and valued the Series A based on a $25 million liquidation preference. The Court of Chancery found that, although Orchard's charter entitled the Series A to a $25 million liquidation preference in a dissolution, asset sale or sale to third-party, none of these circumstances applied to a take-private transaction with Dimensional. Nonetheless, the price negotiation reflected Dimensional's bargaining leverage given the unlikely scenario that any third party would value Orchard high enough to pay the $25 million Series A preference and pay a price for the common stock that would be undiminished by the preference payment.

Orchard's public announcement of Dimensional's initial proposal of $1.68 per share led to third party interest and generated a higher offer by a third party. Dimensional assured the Special Committee that Dimensional would be willing to support a sale to a third party if it received the full liquidation preference. The Special Committee allowed Dimensional to negotiate directly with the third party and at least one other bidder — but no deal was reached. The Court of Chancery found evidence that Dimensional may have misled the Special Committee by negotiating with the third parties for a premium above the Series A liquidation preference.

Meanwhile, in the negotiations between the Special Committee and Dimensional, Dimensional offered $2.10 per share without a majority-of-the-minority approval condition, but eventually agreed on a price of $2.05 per share with a go-shop and a majority-of-the-minority condition. The Special Committee's financial advisor issued an opinion that the price was fair from a financial point of view to Orchard's common stockholders — but the advisor assumed that the Series A should be allocated $25 million of the equity value of Orchard with the rest allocated to the common stock.

Orchard's proxy statement recommended approval of the merger and of an amendment to the Series A Certificate to enable the merger (which otherwise would have prohibited a change of control via a take-private transaction with Dimensional). In July 2010, holders of a majority of the common stock not controlled by Dimensional approved the merger and the transaction closed. After closing, certain stockholders brought an appraisal action. In 2012, then-Chancellor Strine of the Court of Chancery (now Chief Justice of the Delaware Supreme Court) ruled that the merger did not trigger the Series A liquidation preference and appraised the common stock at $4.67 based on an assumed pro rata participation by the Series A on an as-converted basis. Two months later, other stockholders brought a class action challenging the process and price of the transaction.

Vice Chancellor Laster issued a 90-page opinion analyzing issues presented in dueling motions for summary judgment brought by plaintiffs and defendants.

The decision also concludes that, in a controlling stockholder transaction subject to entire fairness review, an exculpatory clause in the company's charter under DGCL § 102(b)(7) does not automatically shield even facially independent and disinterested directors from potential liability where there is evidence of procedural and substantive unfairness indicating a breach of the duty of loyalty. A trial is required to determine whether the transaction was entirely fair, and, if it was not, then an analysis on a director-by-director basis at trial is required to determine whether they committed any breach of loyalty. *In re Orchard* thus diminishes the opportunity for dismissal of facially independent and disinterested directors at an early stage in merger litigation (and increases the potential cost and hassle of service on a special committee). While DGCL § 102(b)(7) remains a strong substantive protection for directors who can reap the benefits of its protection at trial—even when the transaction was not entirely fair — *In re Orchard* meaningfully increases the risk that otherwise "clean" Special Committee members may need to bear the burden of preparation for and participation in a trial, as well as the associated reputational risks.

Finally, the Court held that monetary damages for alleged disclosure deficiencies in soliciting stockholder approval may continue to be available even after a merger closes. Although injunctive relief to correct disclosure deficiencies may be granted before a merger vote in order to prevent "irreparable harm" the Court rejected defendants' inference that there can be no post-closing "remedy" in the form of monetary damages. However, plaintiffs who assert post-closing disclosure-based claims must still prove reliance, causation and quantifiable damages.

The Court granted summary judgment to the plaintiffs on their claim that the proxy statement contained materially misleading disclosures regarding whether the merger triggered the Series A liquidation preference. The Court found that the proxy statement incorrectly stated in two places that the liquidation preference would be triggered unless the amendment was approved. One of those incorrect disclosures was material as a matter of law because the inaccuracy appeared in the description of the amendment to the Series A Certificate, which is a statutorily required disclosure under Section 242(b)(1) of the Delaware General Corporation Law (DGCL).

The Court also granted summary judgment to the plaintiffs on their arguments that the entire fairness standard of review should apply at trial, finding that Dimensional's failure to agree at the outset to approval by both the Special Committee and a majority-of-the-minority precluded review under the business judgment rule. Furthermore, the Court held that neither of those protective measures, even though ultimately deployed, warranted shifting the burden of persuasion from defendants to plaintiffs because (a) the stockholder vote was tainted by the disclosure violation and (b) plaintiffs had raised triable issues of fact as to the integrity of the Special Committee process, including the issues with the chairman described above.

The Court of Chancery rejected the Special Committee members' argument that they were automatically shielded from liability by the DGCL § 102(b)(7) exculpation clause in Orchard's certificate of incorporation. That provision only immunizes directors for breach of the duty of care. Given the context of a controlling stockholder transaction subject to entire fairness review, where there was evidence of both procedural and substantive unfairness, the Court was unable to conclude, as a matter of law, that the evidence did not also implicate the duty of loyalty for all directors. Therefore, the four members of the Special Committee *whose independence and disinterestedness had not been challenged by the plaintiffs* were also required to prove at trial that they did not breach their duty of loyalty and were entitled to exculpation.

Finally, the Court of Chancery denied defendants' argument that rescissory damages and quasi-appraisal damages were unavailable, finding that both measurements were possible given the failure to fully inform the stockholder electorate. (Rescissory damages is the monetary equivalent of rescission; quasi-appraisal damages is essentially monetary damages tied to the difference in equity value resulting from the non-disclosure.) The Court also rejected the defendants' argument that *In re Transkaryotic Therapies, Inc.*, 954 A.2d 346 (Del. Ch. 2008) barred any post-closing claim for money damages for a disclosure violation, finding that a money damages claim is possible where the disclosure violation implicates the duty of loyalty, or where plaintiffs can otherwise prove reliance, causation, and calculable damages.

If you have any questions about this *M&A Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

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