Delaware Court of Chancery provides guidance on standards of review and remedies applicable in controlling stockholder take-private transactions

A recent decision of the Delaware Chancery Court, ***In re Orchard Enterprises, Inc. Stockholder Litigation*, C.A. No. 7840-VCL (Del. Ch. Feb. 28, 2014)**, contains an extensive and helpful discussion of the law applicable to take-private transactions initiated by controlling stockholders.

Notably, the Court in *Orchard* followed recent Chancery Court decisions in holding that the business judgment standard of review potentially can apply to controlling stockholder take-private transactions, but only if several requirements are satisfied. If any of the requirements is not satisfied, the default standard applicable to controlling stockholder take-private transactions - the entire fairness standard - will apply instead. The Court's opinion provides guidance on the application of the entire fairness standard. The Court found that even relatively serious disclosure deficiencies do not necessarily cause a challenged transaction to be procedurally unfair, and that even a large difference between the transaction price and the judicially appraised price does not necessarily cause the transaction to be substantively unfair. The Court also discussed the flexibility that is available to it in crafting remedies when a breach of fiduciary duty is found following a challenge to this type of transaction. The remedies available include "quasi-appraisal damages" and also potentially greater "rescissory damages."

Background

The Orchard Enterprises, Inc. is a Delaware corporation that distributes music and video through digital stores and mobile carriers. In 2009, Dimensional Associates, LLC, which at the time owned approximately 53% of the voting power in Orchard, proposed to take Orchard private through a merger in which the minority stockholders would receive $1.68 per share. Orchard's board of directors formed a special committee to consider the proposal. After negotiations, the special committee and Dimensional agreed to a merger agreement that provided for a price of $2.05 per share, a "go-shop" and a majority-of-the-minority approval condition. In July 2010, the merger was approved at a meeting of Orchard's stockholders.

Some of Orchard's stockholders asserted statutory appraisal rights in respect of their shares, leading to a ruling by the Chancery Court, in 2012, that the fair value of Orchard's common stock at the time of the merger was $4.67 per share. The difference between the appraised value and the price specified in the merger agreement was attributable entirely to the treatment of preferred stock held by Dimensional. For purposes of the merger agreement, that stock was valued as if the merger would be treated as a liquidation, entitling the preferred stock to a liquidation preference. The Chancery Court found in the appraisal proceeding that because of the way the liquidation preference provisions were drafted, the merger was not a liquidation for this purpose. Accordingly, the portion of Orchard's enterprise value properly allocable to the preferred stock was substantially lower than Dimensional had asserted (and the special committee had assumed).

After the entry of the decision in the appraisal proceeding, a class action proceeding was commenced on behalf of the former Orchard minority stockholders, asserting that Dimensional and Orchard's directors had breached their fiduciary duties to the plaintiff stockholders in connection with the take-private transaction.

Decision of the Chancery Court

On the parties' cross-motions for summary judgment, the Court ruled that the entire fairness standard of review applied. Under well established precedent, when the entire fairness standard applies, the controlling stockholder can escape liability only if the court finds that the transaction is entirely fair to the corporation's minority stockholders, and the controlling stockholder bears the initial burden of proof on that issue. That burden can be shifted to the plaintiffs if the controller employs procedural devices such as appointing a committee of independent and disinterested directors to negotiate the transaction, or conditioning the transaction on approval by a majority of the minority stockholders. The Court in *Orchard* acknowledged, and treated as authoritative, a recent series of Chancery Court decisions holding that, if the controller had agreed to both of these procedural devices "up front, before any negotiations began," the business judgment standard (and not the entire fairness standard) would apply.[1] Here, however, when Dimensional made its initial take-private offer it proposed the use of a special committee but not a majority-of-the-minority condition. Dimensional's subsequent acceptance, after negotiations with the special committee, of a majority-of-the-minority condition was not sufficient to change the standard to business judgment. Even though Dimensional's delay in agreeing to a majority-of-the-minority condition deprived it of the benefit of the deferential business judgment standard, it might have hoped that the ultimate use in the transaction of both a special committee and a majority-of-the-minority condition would have sufficed at least to shift the burden of proof on the entire fairness issue to the stockholder plaintiffs, since the use of either of these procedural devices (let alone both) normally is sufficient to shift the burden. Here, however, the Court found flaws in the implementation of each device that prevented burden-shifting. Orchard's proxy statement issued in connection with the merger contained some material misstatements, so the majority-of-the-minority stockholder vote was not fully informed. And the record before the Court presented significant questions as to the independence and disinterestedness of the chairman of the special committee, so the special committee could not be presumed to have operated effectively to protect the interests of the minority stockholders. Thus, the burden of establishing that the transaction was entirely fair remained with Dimensional and the other defendants. In finding that the two protective devices were ineffective to shift the burden of proof on the entire fairness issue, the Court followed well established precedent requiring that the protective devices must be more than merely perfunctory and must effectively insulate the transaction from the influence of the controlling stockholder.

While the Court found that the disclosure problem in Orchard's proxy statement prevented burden shifting, the Court nonetheless declined to rule that as a matter of law the defect in disclosure necessarily made the transaction unfair. Even though the disclosure problem identified by the Court was evidence of an unfair process, it was not outcome determinative. To the contrary, according to the Court, "perfection is not possible, or expected as a condition to a judicial determination of entire fairness." Similarly, while the Court found that the contrast between the merger price of $2.05 and the judicially appraised value of $4.67 "is certainly evidence of financial unfairness," that did not necessarily mean the price Dimensional paid was unfair, because "[a] price may fall within the range of fairness for purposes of the entire fairness test even though the point calculation demanded by the appraisal statute yields an award in excess of the merger price."

In response to the parties' motions, the Court addressed potential damages remedies. The Court found that in a case where, after completion of the merger, defendants were found to have breached their fiduciary duties, there was broad latitude to award damages including in the form of "quasi-appraisal damages" (*i.e.*, damages equal to the difference between the appraised value of the shares and the merger price) and "rescissory damages" (which could be even higher where, for example, the subject company was to be re-sold by the former controlling stockholder for a price higher than both the merger price and the appraised value). In so holding, the Court specifically rejected the defendants' claim that money damages are never appropriate for alleged disclosure violations after the merger has concluded.

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[1] *See* *In re MFW Shareholders Litigation*, 67 A.3d 496, 502-03 (Del. Ch. 2013) discussed in our client briefing issued in June 2013. The *MFW* decision is currently on appeal to the Delaware Supreme Court, which has not yet decided the issue.

Finally, the Court unsurprisingly reached the conclusion that where (as in the case before it), the allegations against the individual director defendants implicated their duties of loyalty, those individuals could not be dismissed from the case on the basis that they were fully exculpated pursuant to Section 102(b)(7) of the Delaware General Corporation Law. Section 102(b)(7) permits exculpation of directors from liability for money damages for breaches of fiduciary duty except those involving the duty of loyalty or good faith.

The existence of duty of loyalty claims made this case different from other recent cases in which claims against directors against whom no substantial allegations of duty of loyalty had been made were dismissed following completion of the merger because at that time there was no relief that could be granted against them. We can expect that Delaware courts will continue to dismiss directors from take-private cases in which the only properly pled claims are duty of care claims and the merger has been completed.

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