SULLIVAN & CROMWELL LLP

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In re Orchard Enterprises, Inc. Stockholder Litigation

Delaware Court of Chancery Provides Guidance on Squeeze-Out Mergers and Entire Fairness Review at Summary Judgment

SUMMARY

In a recent opinion analyzing breach of fiduciary duty claims in a summary judgment context brought more than two years after the consummation of a squeeze-out merger against the target company's directors who approved the merger, the target and its controlling stockholder, the Delaware Court of Chancery (Laster, V.C.) held that:

- following the Court's May 2013 decision in *In re MFW Shareholders Litigation*,[1] which was unanimously affirmed today by the Delaware Supreme Court sitting *en banc*,[2] entire fairness review applies to a squeeze-out merger where the controlling stockholder does not agree up front to condition the transaction on both the affirmative recommendation of a fully-empowered special committee of independent and disinterested directors and approval by a majority of the minority stockholders.
- it is not sufficient just to put procedural protections in place to shift the burden to prove unfairness to the plaintiff; the controlling stockholder and the target's directors must establish the effectiveness of those procedures by establishing either (i) the absence of any genuine issue of material fact with regard to the special committee's independence and disinterestedness (i.e. that it exercised real independent bargaining power and the controlling stockholder did not dictate the terms of the transaction) or (ii) that as a matter of law the majority-of-the-minority vote was fully informed.
- a special committee structure generally only permits burden shifting if the controlling stockholder fully discloses to the committee all material information known to it other than the price at which it will buy or sell and how it would finance a purchase or invest the proceeds of a sale.
- there was insufficient evidence at the summary judgment stage to support a determination that the squeeze-out merger was unfair because factual disputes about the full range of potential disclosure violations by the target's directors and its controlling stockholder and a determination about whether the merger price fell within the range of reasonableness need to be resolved at trial.

- directors could not avail themselves of exculpatory (Section 102(b)(7)) provisions in a company's charter at the summary judgment stage to dismiss breach of fiduciary claims because evidence of procedural and substantive unfairness exists; only after determining entire fairness at trial will the Court be able to decide on a director-by-director basis which directors are entitled to exculpation from liability.
- notwithstanding the passage of time, rescissory damages may be appropriate post-closing where a fiduciary has violated the duty of loyalty and the squeeze-out merger fails the entire fairness test.
- a quasi-appraisal remedy may be appropriate for minority shareholders who are squeezed out by controlling shareholders who breach their duty of disclosure and that disclosure contributes to a finding that the merger fails the entire fairness test; a stockholder seeking post-closing damages for disclosure violations, however, must still prove causation and damages.
- an inaccurate summary of a proposed charter amendment in a meeting notice is material as a matter of law because Delaware law requires the meeting notice to disclose a correct summary of the changes to be effected.
- a corporation has no liability for breaches of fiduciary duty by its directors because the corporation itself does not owe fiduciary duties and cannot aid and abet breaches of fiduciary duty by its fiduciaries.

BACKGROUND

In October 2009, Dimensional Associates, LLC ("Dimensional"), the controlling stockholder of The Orchard Enterprises, Inc. ("Orchard"), which held 42% of Orchard's outstanding common stock and 99% of its outstanding convertible preferred stock that collectively gave it approximately 53% of Orchard's outstanding voting power, formally proposed a squeeze-out merger at a price of $1.68 per share, representing a 25% premium to the then-current stock price. Orchard's board responded by forming a special committee with a mandate that included the right to negotiate or reject a transaction with Dimensional and to solicit interest from other third parties. While four of the five members of the special committee were facially independent, its chair had deep ties to members of the family of the controlling founder of Dimensional. The special committee retained independent legal and financial advisors and negotiated a 16 cent increase in the deal price to $1.84 per share. At a November 2009 meeting, the special committee received its financial advisor's preliminary analysis concluding that Orchard's minority shares had a value of $4.48 per share for purposes of a squeeze-out merger, valuing the convertible preferred stock on an as-converted basis, and not on the basis of its aggregate $25 million liquidation preference that they and Orchard's CFO concurred was not owed by its terms upon a minority buyout by Dimensional.

A former executive of Orchard's predecessor company (the "Third-Party Bidder") thereafter submitted a proposal to acquire all of Orchard's common stock at a price between $2.36 and $2.94 per share and all the convertible preferred stock for a combination of cash and stock in the surviving entity, conditioned on obtaining financing. When the special committee's chair informed it of the higher Third-Party Bidder offer, Dimensional indicated that it would be willing to sell to a third party if it received its full liquidation preference. Based on that representation, the special committee directed the Third-Party Bidder to negotiate directly with Dimensional. Dimensional later informed the special committee that it was not interested in the alternate proposal because it said it had concerns about the financing contingency and the Third-Party Bidder was unwilling to pay the full liquidation preference; according to the plaintiffs, Dimensional was unwilling to sell even though the Third-Party Bidder offered a premium to the full liquidation preference of more than $7 million. On December 11, 2009, the Third-Party Bidder withdrew his proposal.

The special committee ultimately recommended a squeeze-out merger with Dimensional at $2.05 per share with a majority of the minority approval requirement and a go-shop (and a kicker if Dimensional flipped 80% or more of Orchard within six months). Valuing the convertible preferred stock using the full face amount of the liquidation preference, rather than on the as-converted basis of its preliminary analysis, the special committee's financial advisor rendered its opinion that the squeeze-out merger was fair from a financial point of view to Orchard's common stockholders.

During the extended 30-day go-shop period, 23 strategic bidders and 12 financial buyers were contacted, but no formal proposals were submitted.

The Third-Party Bidder thereafter reemerged with a revised proposal that the special committee determined (on the basis of the lack of committed financing) was not reasonably likely to lead to a superior proposal and therefore they could not pursue under the merger agreement's no-shop. On July 29, 2010, the squeeze-out merger was approved by 58% of Orchard's minority stockholders and closed.

Before the stockholders meeting, the chair of the special committee expressed an interest to Orchard in continuing to help Orchard following the merger; he received approximately $40,000 for the consulting work; thereafter he entered into a longer term consulting agreement with Orchard under which he was granted equity and was entitled to receive cash compensation greater than $100,000 annually; his total 2011 remuneration amounted to approximately $270,000.

After the merger closed, various Orchard stockholders pursued a statutory appraisal action that resulted in then Chancellor (now Delaware Supreme Court Chief Justice) Strine ruling that the "fair value" of Orchard's common stock was $4.67 per share, $2.62 more than the per share merger price, based on his decision to value Orchard's convertible preferred stock on an as-converted basis because the liquidation preference was not triggered by the transaction.[3] Following the appraisal judgment, and two years after the merger closed, certain Orchard stockholders filed suit in the Court of Chancery, asserting that Dimensional, the Orchard directors who approved the merger and Orchard's interim CEO breached their fiduciary duties by favoring the controlling stockholder's interests (and, in the case of the special committee chair, his own interests) over the interests of Orchard's minority stockholders. The plaintiffs also named Orchard itself as a defendant, arguing that Orchard could be directly responsible for breaches by its directors and that Orchard aided and abetted breaches of fiduciary duty by Orchard's directors.

The plaintiffs sought summary judgment that Orchard and its directors and Dimensional breached their duties of disclosure insofar as the proxy statement disseminated to stockholders included materially false or misleading statements by (i) stating that the merger triggered the convertible preferred stock's liquidation preference, (ii) allegedly not disclosing that the financial advisor was instructed by the special committee to value the convertible preferred stock based on its liquidation preference, (iii) not disclosing the full extent of the special committee chair's financial and personal connections to the family of the founder of Dimensional and (iv) allegedly omitting the fact that Dimensional's willingness to sell its position depended on third-party bidders paying a premium over the liquidation preference for the convertible preferred stock. The plaintiff's also sought summary judgment that entire fairness was the applicable standard of review for the merger and that as a matter of law the merger was not entirely fair. Among other things, the defendants asserted that the special committee members were exculpated from liability based on Orchard having an exculpatory charter provision under Section 102(b)(7) of the DGCL. Both sides moved for summary judgment on the remedies available under the plaintiffs' theories of liability.

THE COURT OF CHANCERY'S DECISION

A. MISSTATEMENTS IN DISCLOSURE REQUIRED BY THE DGCL ARE MATERIAL AS A MATTER OF LAW

The Court concluded that Orchard's meeting notice incorrectly stated that a charter amendment was required to avoid triggering the convertible preferred stock's liquidation preference at the closing of the merger and that this misstatement was material as a matter of law because Section 242(b)(1) of the DGCL required the meeting notice to disclose an accurate summary of the charter changes to be effected. The Court declined to grant plaintiffs summary judgment on their other disclosure claims, finding that trial is needed to resolve material factual disputes about their accuracy.

B. ENTIRE FAIRNESS APPLIES TO THE SQUEEZE-OUT MERGER; BURDEN OF PROOF REMAINS WITH DIRECTORS/COMPANY/CONTROLLING STOCKHOLDER

Citing to *In Re MFW*, the Court held that entire fairness review applies to the squeeze-out merger because Dimensional did not agree up front to condition the transaction on both the affirmative recommendation of a fully-empowered special committee of independent and disinterested directors and approval by a majority of Orchard's minority stockholders.[4]

Moreover, the Court concluded that burden shifting to the plaintiffs was not appropriate because (i) Dimensional and Orchard's directors failed to establish that the majority-of-the-minority vote was fully informed (based on the Court's conclusion that Orchard's meeting notice incorrectly summarized the charter amendment) and that trial evidence may show that other disclosures were materially false or misleading and (ii) Dimensional and Orchard's directors failed to establish the absence of any material factual dispute with regard to the special committee directors' independence and disinterestedness and the effectiveness of the special committee's work. First, the Court found that there are genuine material issues of fact with regard to the independence of the special committee's chair – the principal negotiator and central conduit for information flowing to and from the special committee – based on his past business and social connections with the family of the founder of Dimensional and his consulting work for Orchard after the closing of the transaction. Second, the Court found that Dimensional may have misled the Special Committee about its willingness to sell to a third party on commercially reasonable terms (i.e. in exchange for payment of the liquidation preference, a representation that led the special committee to permit third parties to bargain directly with Dimensional). Third, the Court found genuine material issues of fact as to whether the special committee valued the convertible preferred stock based on the aggregate $25 million liquidation preference to favor Dimensional by driving down the valuation of Orchard's common stock or whether its financial advisor independently arrived at the result. The Court indicated that a special committee structure generally only permits burden shifting if the controlling stockholder fully discloses to the committee all material information known to it other than the price at which it will buy or sell and how it would finance a purchase or invest the proceeds of a sale, finding that Dimensional's representations about its willingness to sell to a third party were "highly material" because the special committee routed third-party bids to Dimensional and relied on the go-shop as validating the fairness of the merger, which the Court noted only had value to the extent Dimensional was willing to sell.[5]

Although the Court concluded that the burden of persuasion to demonstrate the entire fairness of the squeeze-out merger would remain with Dimensional and Orchard's directors during trial, it stressed that even though the controlling stockholder did not commit to the use of a special committee and the majority-of-the-minority vote condition up front, the use of such devices was not irrelevant because proof of the effectiveness of one or both of those devices will significantly influence the Court's determination of fairness and any potential remedy at trial.

Finally, the Court declined to grant summary judgment on the issue of whether the merger was entirely fair noting that although the inaccurate summary of the charter amendment in Orchard's meeting notice and the appraisal decision's "fair value" judgment of $4.67 per share (more than double the merger price) provided some evidence of procedural and substantive unfairness, trial was needed because a single disclosure violation may not be outcome-determinative (and factual issues remain about the existence of other disclosure violations and possible misrepresentations by Dimensional regarding its willingness to sell to third parties) as the merger price may fall within the range of reasonableness.

Separately, the Court also noted that Orchard (who was named as a defendant by the plaintiffs) could not be liable for breaches of fiduciary duty by members of its board of directors or for aiding and abetting any such breaches, finding that the fiduciaries who serve a corporation owe fiduciary duties but the corporation that they serve does not and that a corporation cannot aid and abet violations by the fiduciaries who serve it.

C. EXCULPATORY (SECTION 102(B)(7)) PROVISIONS GENERALLY WILL NOT RESULT IN SUMMARY JUDGMENT FOR DIRECTORS WHERE ENTIRE FAIRNESS REVIEW APPLIES

The Court rejected the defendant directors' attempt to obtain summary judgment in their favor based on Orchard having an exculpatory clause in its charter for breaches by directors of the duty of care. Explaining that the litigable issue on the question of whether the directors acted in good faith is whether "when push came to shove" the directors favored Dimensional over the minority stockholders, the Court held that when entire fairness review applies and there is evidence at the summary judgment phase of procedural and substantive unfairness, exculpatory clauses under Section 102(b)(7) of the DGCL cannot be applied to dismiss a case even where the directors are facially independent and disinterested.[6] Only at trial, the Court explained, after trying the issue of entire fairness can the Court then examine on a director-by-director basis which directors have the right to be exculpated, noting that even if the transaction were not found to be entirely fair, the directors could still prove that the failure was attributable to a violation of their duty of care as opposed to a violation of their duty of loyalty. In negotiating with Dimensional, the Court stated, the members of the special committee owed a duty of loyalty to Orchard's shareholders "to seek the alternative that maximized the value of their residual claims without regard to the particular interests of the controller."[7]

D. RESCISSORY DAMAGES AND QUASI-APPRAISAL REMEDIES MAY BE AVAILABLE FOR FAILURE TO SATISFY THE ENTIRE FAIRNESS TEST AND BREACHES OF DUTY OF DISCLOSURE

The Court also rejected Dimensional's attempt to obtain summary judgment relief on the plaintiffs' claim for rescissory damages (the monetary equivalent of rescission). The Court concluded, consistent with Delaware Supreme Court holdings, that rescissory damages – measured at the time the Court would conclude it was equitable, whether at the time of judgment, resale, or "at an intervening point when the stock had a higher value and remained in control of the disloyal fiduciary" – may be awarded against any director found to have violated his or her duty of loyalty, if the Court determines that the squeeze-out merger was not entirely fair, notwithstanding the passage of time.[8]

The Court also indicated that a quasi-appraisal remedy – the amount of money a stockholder would have received in a statutory appraisal based on the Court of Chancery's "fair value" determination (i.e. $2.62 in this instance based on the Court's finding in the appraisal action that the "fair value" of Orchard's common stock was $4.67 per share) – would be one form of remedy available to the plaintiffs if the Court were to find that Dimensional breached its duty of disclosure and that the breach contributed to a finding that the squeeze-out merger failed the entire fairness test. Rejecting the defendants' argument that post-closing damages could not be awarded for disclosure violations, the Court pointed out that if the disclosure had been adequate, the stockholders could have voted against the merger and remained equityholders; deprived of that ability, they were entitled to monetary damages. However, the Court stressed that a stockholder seeking post-closing damages for disclosure violations must prove causation and damages, noting that such issues are subsumed within the entire fairness test when that standard applies.

E. TAKE-AWAYS

The Court's decision:

- Reiterates the position taken by now Delaware Supreme Court Chief Justice Strine in *In Re MFW*, which was unanimously affirmed today by the Delaware Supreme Court, that a squeeze-out merger will be subjected to entire fairness review if the controlling stockholder does not condition the transaction at the outset on approval by both a fully-empowered special committee of independent and disinterested directors and a majority of the minority stockholders.
- Serves as a useful reminder that care should be taken in drafting disclosure specifically required by the DGCL because inaccurate or misleading statements in any such disclosure will be deemed material as a matter of law.
- Reinforces the importance of going beyond facial independence in selecting members for a special committee.
- Highlights the extent of disclosure required by controlling stockholders to special committees to permit burden shifting – full disclosure of all material information known to it other than the price at which it will buy or sell and how it would finance a purchase or invest the proceeds of a sale.
- Highlights that disloyal fiduciaries may be subject to rescissory damages (as an alternative to quasi appraisal) in lawsuits filed after a squeeze-out merger has closed if the transaction fails the entire fairness test.
- Serves as a useful reminder that exculpatory clauses may not be adequate to ensure summary judgment in cases involving entire fairness.
- Emphasizes that disclosure violations arising from transactions requiring a stockholder vote could result in post-closing liability, including quasi-appraisal damages.

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ENDNOTES

1 67 A.3d 496 (Del. Ch. 2013). For a full discussion of then Chancellor (now Delaware Supreme Court Chief Justice) Strine's *In Re MFW* decision, see our publication, dated June 3, 2013, entitled "*In re MFW Shareholders Litigation*."

2 *See Kahn v. M&F Worldwide Corp.*, No. 334, 2013, slip op. at 18 (Del. Mar. 14, 2014) ("[I]n controller buyouts, the business judgment standard of review will be applied *if and only if*: (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority."). *In Re MFW* requires that the controlling stockholder agree upfront to unwaivable procedural protections in order to obtain the benefit of the business judgment rule. Vice Chancellor Laster did not need to address these issues in *Orchard* because the controlling stockholder never agreed at the outset to condition its buyout on the procedural protections required by *In Re MFW*.

3 *See In re Orchard Enterprises, Inc.*, 2012 WL 2923305 (Del. Ch. July 18, 2012).

ENDNOTES (CONTINUED)

[4] The Court emphasized that if the controller only agrees to use one of the procedural protections identified by *In Re MFW*, or does not agree to both protections up front, then the most it can achieve is a burden shift requiring that the challenging stockholder prove unfairness. Such an approach is consistent with today's ruling by the Delaware Supreme Court affirming *In Re MFW*. *See M&F Worldwide Corp.*, No. 334, 2013, slip op. at 19.

[5] *In re Orchard Enterprises, Inc. Stockholder Litigation*, C.A. No. 7840-VCL, slip op. at 40-41 (Del. Ch. Feb. 28, 2014). The Court noted that the special committee had no reason to consider measures to counterbalance Dimensional's influence and prevent it from acting contrary to Orchard's other stockholders based on its representations that it was a willing seller if it received the full liquidation preference; had the special committee thought otherwise, the Court indicated that it could have opposed or constrained Dimensional, finding that directors have no duty to serve the interests of a controller and may take certain reasonable actions that discriminate against a stockholder to protect the corporation.

[6] *Id.* at 58.

[7] *Id.* at 55.

[8] *Id.* at 60. The Court noted that the passage of time plays a role in the availability of rescissory damages but indicated that Delaware courts have previously found rescissory damages an appropriate remedy for transactions consummated up to ten years before the damages ruling.

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