

M&A Update

Delaware Court's Orchard Enterprises Decision Provides Key Insights For Special Committees In Controlling Stockholder Transactions

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On March 14, 2014, the Delaware Supreme Court upheld the Court of Chancery's 2013 decision in *In re MFW Shareholders Litigation*, holding that in going-private mergers where there is a controlling stockholder, the use of both a truly independent special committee and a majority of the minority stockholder vote, allows for judicial review under the deferential business judgment standard. Vice Chancellor Laster's decision two weeks earlier in *In re Orchard Enterprises, Inc. Stockholder Litigation* applied the Chancery Court decision in *MFW* but found that business judgment rule review was not appropriate. *Orchard* demonstrates that *MFW* is not a magic bullet and that boards and their advisors need to take care if they wish to obtain a more favorable standard of judicial review based on that decision.

Background

In July 2010, Orchard Enterprises was acquired in a going-private transaction by its controlling stockholder, Dimensional Associates. At the time of the transaction, Dimensional owned 42% of Orchard's common stock and 99% of Orchard's Series A preferred stock, representing approximately 53% of Orchard's voting power. As a result of the transaction, the minority common stockholders of Orchard were squeezed out at a price per share of \$2.05.

The transaction was approved by a 5-member special committee. In addition, the transaction was approved by a majority-of-the-minority stockholder vote and the transaction agreement included a go-shop provision allowing the special committee to seek superior proposals.

Former Orchard stockholders filed suit after an appraisal proceeding found that the fair value of Orchard's common stock at the time of the merger was \$4.67 per share. The court faulted the committee's sale process, the disclosures made to shareholders and the financial advisor's fairness opinion. It also ruled that the minority protections were inadequate to avoid "entire fairness" review, or to shift the burden of proof from the defendants to the plaintiffs.

Takeaways

The *Orchard* decision provides key insights for controlling stockholders, sellers and their advisors on the appropriate role and conduct of a special committee and the use of minority stockholder protections in going-private transactions involving controlling stockholders.

1. Pre-Negotiation Conduct. The court made clear that a controlling stockholder transaction will be subject to deferential business judgment review under *MFV* (which was affirmed by the Delaware Supreme Court after *Orchard* was decided) only if the controlling stockholder agrees “up front, before any negotiations begin,” not to proceed absent approval from both an independent special committee and a vote of a majority of minority stockholders. Dimensional did not agree to these conditions up front. As a result, the more rigorous entire fairness standard applied notwithstanding the special committee’s favorable recommendation and majority-of-the-minority approval. If a controlling stockholder wishes to achieve business judgment review of the transaction, the controlling stockholder and its advisors should: (i) determine whether the transaction should include minority protections necessary to achieve business judgment review prior to engaging in negotiations with the company; and (ii) expressly condition its willingness to proceed with the transaction on satisfaction of those minority protections.
2. Special Committee Independence. The court concluded that Orchard’s use of a special committee did not shift the burden of proving entire fairness to minority stockholder plaintiffs because there were material questions as to whether the chairman of the committee was disinterested and independent. The court cited evidence of the director’s social and business ties to the family of Dimensional’s senior executive officer, and the chairman’s pre-closing agreement to provide consulting services for Dimensional after the transaction closed. Caution must be exercised in vetting committee members’ material ties to the controlling stockholder, particularly the committee’s “most influential figure.” Here, questions surrounding the independence of one committee member tainted the entire committee. Committee members also should take care not to enter into post-closing arrangements that may call his or her independence into question.
3. Majority-of-the-Minority Condition and Disclosure. The decision emphasizes the importance of providing accurate disclosure to minority stockholders in going-private transactions. The court ruled that there was at least one inaccurate statement in the proxy statement, and this statement was automatically deemed material because it was part of the disclosure mandated under Delaware law. As a result, even though a majority of the minority voted for the deal, the inaccurate disclosure rendered the vote ineffective to shift the burden to stockholders to prove entire fairness. Companies and their advisors should be mindful of the potentially harsh consequences that may flow from providing inaccurate shareholder disclosure, particularly where the information is required by law.

4. Honest and Forthcoming Dealings with Committee. The court cited evidence that Dimensional misled the committee about its willingness to sell the company to a third party on commercially reasonable terms. The committee relied on this “highly material information” to make certain decisions, such as allowing Dimensional to directly negotiate with third party bidders and negotiating for a go-shop provision in the transaction agreement. The court stated that “if Dimensional misled the Special Committee, then it will be virtually impossible for Dimensional to establish” entire fairness. In addition to being honest and transparent with a special committee, controlling stockholders must not unduly influence the committee or its advisors or otherwise inject themselves into the sale process. Committees also should proceed cautiously in delegating any aspect of the sale process to the controlling stockholder.
5. Fairness Opinion. Despite conducting preliminary analyses that valued Dimensional's Series A preferred stock on an as-converted basis, the financial advisor's final opinion valued the Series A preferred stock using its full liquidation preference. There was evidence that the committee directed this change, which drove down the acceptable value of the common stock. This situation underscores that: (i) courts are subjecting fairness opinions, especially the underlying assumptions, to significant scrutiny; (ii) material revisions to those assumptions that favor the controlling stockholder will subject the integrity and value of the opinion to challenge by minority stockholders; and (iii) committees should not direct, or appear to direct, the advisor's analysis in a manner favorable to the controlling stockholder.

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If you have any questions, please contact any of the following attorneys or your Cadwalader contact:

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