Young Conaway Stargatt & Taylor, LLP
Attorneys at Law

Winter 2009

Delaware Transactional & Corporate Law Update

Case Law Developments: Terms of Equity Capital Raised in Unfair Transaction Reformed by Court

by Evangelos Kostoulas

In remedying a self-dealing transaction between a corporation and its controlling stockholder, the Delaware Court of Chancery reformed the terms of a securities-purchase agreement, converting the preferred stock issued under the agreement into non-voting common stock. *In re Loral Space & Communications, Inc. Consol. Litig.*, C.A. Nos. 2808-VCS, 3022-VCS, 2008 Del. Ch. LEXIS 136 (Del. Ch. Sept. 19, 2008), *aff'd sub nom. Loral Space & Communications, Inc. v. Highland Crusader Offshore Partners, L.P.*, 977 A.2d 867 (Del. 2009).

After Loral Space & Communications emerged from bankruptcy in 2005, its largest shareholder was MHR Fund Management LLC, owning 35.9% of Loral's common stock. Two of Loral's directors, Michael B. Targoff and John D. Harkey, Jr., were investment advisors to MHR. Targoff was also made Loral's CEO by MHR. Three other Loral directors were managing principals of MHR, including Mark H. Rachesky, MHR's founder, who served as Loral's chairman. Additionally, Rachesky had been a business school classmate of Harkey, and the two had stayed friends and acted as business references for each other.

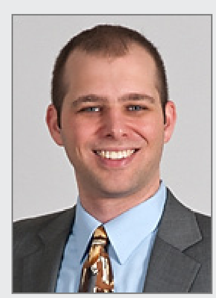
Soon after Targoff became CEO, he sought, in consultation with Rachesky, to have Loral allow MHR to make a $300 million equity investment, "an investment equal to over half of Loral's existing stock market capitalization." *Id.* at *4. The Loral board appointed a two-person special committee to negotiate the proposed deal. Harkey was appointed chairman of the special committee and served on it with Arthur L. Simon, who had had no recent substantial involvement with the business world outside of his service on Loral's board.

Although Targoff had business plans for Loral that required capital, none of them required funding immediately. However, the special committee's "mandate" was to raise not less than $300 million in equity "quickly." *Id.* at *30. To assist it with this mandate, the special committee hired North Point Advisors LLC, a small investment bank headed by an individual with no graduate training in business or economics. North Point advised the special committee that Loral's best option was to sell convertible preferred stock to MHR, and that Loral "should pay a dividend between 5% and 7.5% and that the conversion premium should be 12% to 15%." *Id.* at *35. North Point did not conduct a market check before making this recommendation. Nevertheless, the special committee ultimately decided to give MHR the highest coupon and lowest conversion premium recommended by North Point and paid MHR a $6.75 million placement fee.

Additionally, in order not to give MHR a majority stake in Loral and thereby subject the Loral board of directors to "*Revlon* duties," the special committee fashioned the conversion terms of the preferred stock such that MHR's voting power would not exceed 39.999%. Nevertheless, "the class voting rights it acquired gave MHR a unilateral veto over any strategic initiative Loral undertook." *Id.* at *6.

Loral stockholders brought suit to challenge the MHR deal. In its post-trial opinion, the Court of Chancery first determined whether the entire fairness standard applied

Meet the Author:



Associate **Evangelos ("Andy") Kostoulas** practices primarily in the commercial transactions area with a focus on mergers and acquisitions, the structure and use of Delaware entities, and the rendering of legal opinions.

ekostoulas@ycst.com
302.576.3589

to the transaction. The entire fairness standard would apply if MHR was the controlling stockholder of Loral, or if the majority of the Loral board was not disinterested and independent as to the transaction. In this case, the court found, both were true. A stockholder is controlling if, "'as a practical matter, [he] possesses a combination of stock voting power and managerial authority that enables him to control the corporation, if he so wishes.'" *Id.* at *72 (*quoting In re Cysive S'holders Litig.*, 836 A.2d 531, 553 (Del. Ch. 2003)). MHR had significant power over Loral and used that power to influence the financing process. Additionally, five out of the eight Loral directors were affiliated with MHR at the time the financing was agreed to. Thus, the deal was examined to determine whether it was entirely fair to Loral and its stockholders other than MHR.

The court next looked at the special committee, to determine whether it "functioned as an effective proxy for arms-length bargaining, such that a fair outcome equivalent to a market-tested deal resulted." The court found that neither the special committee formed by Loral's board, nor the committee's financial advisor, adequately protected the interests of Loral. Likewise, the court found, the price obtained by MHR in its negotiations with the committee was better than market.

For all these reasons, the defendants failed to show that the MHR deal was entirely fair. The remedy that the court then settled upon was "to take MHR and the Special Committee up on their desire to avoid a *Revlon* deal, and to reform the Securities Purchase Agreement to convert the Preferred Stock that MHR received into non-voting common stock on terms fair to Loral." *Id.* at *116. The court therefore divided the dollar amount MHR had invested by what the court determined to be a fair per-share price for Loral stock, and ordered that the quotient would represent the number of non-voting common shares to be issued to MHR. As the court explained, "MHR will hold 57% of the total equity of Loral, . . . but remain at its prior level of voting power (35.9%). . . . At the same time, the remedy rectifies the harm to Loral and its public stockholders from an unfair, non-market tested transaction that saddled the corporation with an unwieldy capital structure and a future in which MHR held unilateral veto power over virtually any major decision the Loral board made." *Id.* at *119-20.

The atypical form of relief ordered in *Loral* illustrates the Court of Chancery's willingness, when circumstances warrant, to use its equitable powers to devise remedies particularly suited to the circumstances at the time judgment is entered. By changing the terms of the MHR deal to make them fair, the court avoided a forfeiture while putting Loral and its other stockholders in the position they likely would have been in if an arm's-length transaction had been negotiated.

Cases To Watch: *In re SemCrude*

On June 19, 2009, the United States Bankruptcy Court for the District of Delaware issued three opinions in the *SemCrude* bankruptcy addressing questions of first impression. *In re SemCrude, L.P.*, 407 B.R. 82 (Bankr. D. Del. 2009); *In re SemCrude, L.P.*, 407 B.R. 112 (Bankr. D. Del. 2009); *In re SemCrude, L.P.*, 407 B.R. 140 (Bankr. D. Del. 2009). One opinion (407 B.R. 140) addressed whether an Oklahoma statute created an implied trust, thereby keeping certain assets outside of the Debtor's bankruptcy estate and preventing the creditors' security interests from attaching thereto. The other two opinions addressed the extent to which non-uniform amendments to the Uniform Commercial Code (UCC) adopted by certain states are applicable to perfect security interests.

These latter two opinions (the "UCC Opinions") are particularly noteworthy because of their broader applicability, though all three have been appealed directly to the Third Circuit Court of Appeals. In the UCC Opinions, certain creditors owning oil and gas wells located in Kansas and Texas claimed to hold automatically perfected purchase money security interests under non-uniform amendments to the Kansas and Texas UCC. Thus, the pivotal issue in each of the UCC Opinions was which state's law applied in determining whether a security interest was perfected. "Given the uniformity found in most states' versions of Article 9 of the UCC, choice of law issues regarding security interests are rarely litigated." 407 B.R. at 95. Because the dispute was brought before the bankruptcy court sitting in Delaware, Delaware choice of law provisions applied, though the court noted that each of the states relevant to the disputes in the UCC Opinions had adopted the standard UCC choice of law provision. *See* 407 B.R. at 104, 105 n.13; 407 B.R. at 133 & n.11; *see also* U.C.C. § 9-301. Section 9-301 of the UCC sets forth the general rule that, when a debtor is located in a particular jurisdiction, the local law of that jurisdiction governs perfection of a security interest in collateral. Because the debtors were Delaware and Oklahoma entities, Delaware and Oklahoma law applied. Since the court held that the non-uniform amendments did not fall outside the scope of the UCC, those statutes were not recognized under either Delaware or Oklahoma law to create a priority superior to that of creditors properly perfected under Delaware or Oklahoma law.

The court undertook a similar analysis with respect to other non-possessory security interests that, claimants asserted, were perfected under non-uniform UCC provisions enacted in states other than Delaware and Oklahoma. As a result, the claims of the creditors relying on inapplicable non-uniform amendments for perfection were subordinate to those of creditors who were properly perfected under the applicable state's laws. For the present, at least, the UCC, as adopted in Delaware, will generally govern perfection of security interests in collateral owned by Delaware entities, notwithstanding any non-uniform amendments to the UCC in a state where the collateral originated.

Inadequate Disclosure in Short-Form Merger Remedied with Quasi-Appraisal Procedure

by Evangelos Kostoulas

A recent decision by the Delaware Supreme Court highlights the importance of the fiduciary duty of disclosure in short-form mergers. In *Berger v. Pubco Corp.,* 976 A.2d 132 (Del. 2009), the court held that where a fiduciary breaches his duty of disclosure in a short-form merger, the appropriate remedy is quasi-appraisal without requiring minority stockholders to "opt-in" or escrow any merger proceeds.

In *Berger*, the defendant, Robert H. Kanner, owned over 90% of Pubco Corporation's outstanding stock. Under Delaware law, a corporation owning 90% of another corporation's outstanding voting stock may unilaterally effect a merger of the two corporations. (8 *Del. C.* § 253.)

In order to avail himself of the benefits of Delaware's short-form merger statute, Kanner formed a corporation and transferred all of his Pubco stock to that corporation. A short-form merger was then effected between the new corporation and Pubco, and the minority stockholders of Pubco were thereby cashed out.

As required by statute, Kanner sent a written notice advising the minority stockholders of the merger, including with it a copy of the appraisal statute as in effect prior to its most recent (2007) amendments. The merger notice also disclosed information about Pubco's business, including Pubco's most recent interim and annual unaudited financial statements. "No disclosures relating to the company's plans or prospects were made, nor was there any meaningful discussion of Pubco's actual operations or disclosure of its finances by division or line of business." *Id*. at 135. No indication was given of how the merger consideration of $20 per share had been determined.

The Court of Chancery held that the notice was defective for two reasons. First, the copy of the appraisal statute was outdated, and an updated copy was never sent to the minority stockholders. Second, the notice failed to provide any indication of the pro-

In a case of first impression, the Delaware Supreme Court held that the proper remedy for a breach of the duty of disclosure in a short-form merger is to allow minority stockholders quasi-appraisal without requiring them to opt in or place the merger consideration into escrow.

cess used to determine the price offered for the minority's shares. Under *Glassman v. Unocal Exploration Corporation*, 777 A.2d 242 (Del. 2001), sufficient information must be disclosed in a notice of short-form merger to allow the minority stockholders to make an informed decision regarding whether to accept the merger consideration or instead seek appraisal.

Having determined that the duty of disclosure had been breached, the Court of Chancery next decided the appropriate remedy. Since the failure to disclose material information prevents minority stockholders from knowing whether to avail themselves of statutory appraisal rights, quasi-appraisal was held to be the appropriate remedy. However, quasi-appraisal comes in many forms.

In fashioning the appropriate quasi-appraisal remedy, the Court of Chancery considered two decisions dealing with disclosure breaches in short-form cash-out mergers: *Nebel v. Southwest Bankcorp, Inc.*, C.A. No. 13618, 1995 Del. Ch. LEXIS 80 (Del. Ch. July 5, 1995), which was decided pre-*Glassman*, and *Gilliland v. Motorola, Inc.*, 873 A.2d 305 (Del. Ch. 2005), which was decided post-*Glassman*. In *Nebel*, the stockholders were awarded quasi-appraisal without having to "opt-in," while in *Gilliland*, the court required stockholders who opted in to the quasi-appraisal to escrow a portion of their merger consideration. The court followed the latter approach.

On appeal, the parties contested only the remedy awarded by the Court of Chancery. In a case of first impression, the Delaware Supreme Court held that the proper remedy for a breach of the duty of disclosure in a short-form merger is to allow minority stockholders quasi-appraisal without requiring them to opt in or place the merger consideration into escrow. In so holding, the court considered four different options: the two considered by the Court of Chancery, as well as a suit for breach of fiduciary duty under the entire fairness standard and a "replicated appraisal." In the "replicated appraisal" remedy, stockholders would decide whether or not to elect appraisal after receiving, in a supplemental disclosure, all information material to that decision. Those who elect appraisal would remit their merger consideration to the corporation, and an appraisal action would be commenced under the terms of the appraisal statute.

In selecting the most appropriate remedy, the Supreme Court looked at the policies underpinning the *Glassman* decision, as well as the appraisal and short-form merger statutes. The Court concluded that a suit for breach of fiduciary duty was the least appropriate remedy, as it would frustrate the General Assembly's intent that appraisal be the sole remedy for a short-form merger. A replicated appraisal was also dismissed by the court, as such a remedy would be unfair to the plaintiffs and, imposing negligible additional cost, would provide little incentive for fiduciaries to fulfill their duties of disclosure in short-form mergers.

As between the remaining two potential remedies, the court reasoned that an opt in requirement would unfairly pose a greater burden on stockholders than an opt-out requirement. Similarly, the court held that fairness required that the appraisal statute "be construed evenhandedly, not as a one-way street." *Berger*, 976 A.2d at 144. "In fairness, majority stockholders that deprive their minority shareholders of material information should forfeit their statutory right to retain the merger proceeds payable to shareholders who, if fully informed, would have elected appraisal." *Id.*

Berger thus underscores the importance of giving stockholders all material information when cashing them out in a short-form merger. In addition, while the case reiterated that appraisal is the sole remedy available to minority stockholders who challenge the fairness of a short-form merger, the appraisal procedure will be more stockholder-friendly when it is ordered as a remedy to a breach of the fiduciary duty of disclosure.

2009 Amendments to the Delaware Limited Liability Company Act and Limited Partnership Act

by John J. Paschetto

In statutory amendments effective August 1, 2009, the Delaware legislature confirmed that the doctrine of independent legal significance applies to Delaware limited liability companies (LLCs) and limited partnerships (LPs), and not only to Delaware corporations. In addition, among other changes, the legislature confirmed that the prerequisites for amending an LLC or LP agreement outside of a merger do not necessarily apply when the agreement is amended in a merger; confirmed that the Delaware Court of Chancery has jurisdiction over actions seeking interpretation of documents contemplated by the LLC and LP Acts; and reduced the taxes owed when an LLC or LP is revived.

Doctrine of Independent Legal Significance

The doctrine of independent legal significance has been developed by Delaware courts in construing the Delaware General Corporation Law (the DGCL). Under the doctrine, a transaction that can be effected pursuant to any one of several provisions of the DGCL is not infirm simply because the requirements of one such provision were met while those of alternative provisions were not. For example, as the Delaware Supreme Court explained in *Elliott Associates, L.P. v. Avatex Corp.,* the class voting rights granted in DGCL § 242 (respecting corporate charter amendments) are not necessarily available when a charter is amended in the course of a merger as permitted under DGCL § 251. (715 A.2d 843, 853 n.48 (Del. 1998).)

While the doctrine has long been a well-established part of Delaware corporate jurisprudence, it has not been expressly held to govern construction of the LLC and LP Acts. Thus, in 2007, the Delaware Court of Chancery noted in dicta that "[w]hether the doctrine of independent legal significance applies in the context of a limited partnership dispute is an open question in this State." *Twin Bridges LP v. Draper*, C.A. No. 2351-VCP, 2007 Del. Ch. LEXIS 136, at *34 n.47 (Del. Ch. Sept. 14, 2007). That question has now been answered in the affirmative by the 2009 amendments to the Delaware LLC and LP Acts.

The amendments added new subsection (h) to § 18-1101 of the LLC Act and § 17-1101 of the LP Act: "Action validly taken pursuant to 1 provision of this chapter shall not be deemed invalid solely because it is identical or similar in substance to an action that could have been taken pursuant to some other provision of this chapter but fails to satisfy 1 or more requirements prescribed by such other provision." As explained in the legislative synopses accompanying the amendments, the new subsection refers to "the doctrine of independent legal significance, as developed in Delaware corporation law," and "is not intended to limit development or application" of the doctrine. (Del. S.B. 82 syn., 145th Gen. Assem. (2009) (amendments to LLC Act); Del. H.B. 142 syn., 145th Gen. Assem. (2009) (amendments to LP Act).)

Amendments to LLC and LP Agreements through Mergers

The amendments incorporating the doctrine of independent legal significance in the LLC and LP Acts refer specifically to statutory requirements. They thus leave open the question whether an analogous rule may be used when construing LLC and LP agreements. Insofar as that question relates to amending an LLC or LP agreement in the course of a merger, it is answered in amendments to the statutory sections dealing with mergers involving LLCs and LPs. (6 *Del. C.* §§ 18-209 (LLCs), 17-211 (LPs).)

In each section, a clause was added to confirm that provisions in an LLC or LP agreement pertaining to amendment of the agreement do not pertain to amendment *specifically in the course of a merger*, unless the provisions so state. (6 *Del. C.* §§ 18-209(f), 17-211(g).) Thus, if an LLC agreement requires that an amendment be approved by members owning three-quarters of the LLC, while a merger must be approved by members owning only a majority, the LLC agreement can be amended in a merger with majority approval unless it specifies that three-quarter approval is required for amendments in a merger. This conclusion also arguably resulted from the previous versions of §§ 18-209(f) and 17-211(g), but the 2009 amendments have made it clear.

The amendments also added two types of changes that can be made, in the course of a merger, to a certificate of formation or certificate of limited partnership when the surviving entity is a domestic LLC or LP, respectively. (Unlike an LLC or LP agreement, a certificate of formation or certificate of limited partnership is publicly filed with the Delaware Secretary of State.) Formerly, when a domestic LLC or LP was the surviving entity in a merger, the only change that could be made to the certificate was in the entity's name. Now the surviving entity's registered office and registered agent may be changed as well. (6 *Del. C.* §§ 18-209(c)(4), 17-211(c)(4).)

A potential ambiguity regarding the execution of merger certificates under the LLC Act has also been removed by the 2009 amendments. Section 18-204 previously did not specify who is to execute a certificate of merger or consolidation when the surviving or resulting entity is something other than a Delaware LLC. As amended, § 18-204(a) now provides that, in such a situation, the certificate of merger or consolidation "shall be executed by any person authorized to execute such certificate on behalf of such other business entity." No corresponding amendment was needed to the LP Act, which already was clear on this issue. (*See* 6 *Del. C.* § 17-204(a)(4).)

Court of Chancery Jurisdiction

Access to the Delaware Court of Chancery is essentially limited to actions seeking equitable relief and those brought pursuant to statutory grants of jurisdiction over specific subject matters. Both the LLC Act and the LP Act contain several such statutory grants, including sections providing for Court of Chancery jurisdiction over actions seeking interpretation and enforcement of LLC and LP agreements. (6 *Del. C.* §§ 18-111, 17-111.)

The 2009 amendments make clear that the jurisdictional grants in §§ 18-111 and 17-111 cover actions to interpret or enforce provisions of the LLC and LP Acts themselves, and (in addition to LLC and LP agreements) "any other instrument, document, agreement or certificate contemplated by any provision" of the LLC and LP Acts.

Changed Fees and Taxes

The fees for filing documents with the Delaware Secretary of State were increased in varying amounts by amendments to §§ 18-1105 and 17-1101 of the LLC and LP Acts, respectively. This was the first such increase since 2003. In addition, the penalty for failure to pay the annual Delaware franchise tax on time was increased from $100 to $200. (6 *Del. C.* §§ 18-1107(e), 17-1109(d).)

Finally, the 2009 amendments reduced the amount to be paid when an LLC or LP is revived after its certificate of formation or certificate of limited partnership has been canceled for failure to pay taxes or failure to comply with the provisions regarding registered agents. Previously, a reviving entity was required to pay, among other fees, the annual state franchise tax for each year during which it was not paid, up to the year of revival. The amendments lessened that burden, by requiring that the entity pay only the annual franchise tax that was due at the time its certificate was canceled. (6 *Del. C.* §§ 18-1109(a), 17-1111(a).)

About the Update

The Delaware Transactional & Corporate Law Update is published by the Business Planning and Transactions section of Young Conaway Stargatt & Taylor, LLP.

Young Conaway, based in Wilmington, Delaware, is among the state's largest law firms, with over 100 attorneys in 10 practice sections that include bankruptcy, corporate, intellectual property, employment law, tax, banking and real estate practices.

The Business Planning and Transactions section handles matters arising at every stage in the formation, growth and development of corporations, limited liability companies, limited partnerships, statutory trusts and other types of entitites, including those formed as special purpose entities in securitization and other structured transactions. The section's attorneys combine experience in Delaware corporate law, alternative-entity law, tax, commercial transactions and bankruptcy reorganizations.

To receive a complimentary subscription to this publication, please send an e-mail with your contact information to info@ycst.com or visit our web site at www.YoungConaway.com. To opt out of an e-mail subscription, please send your name and e-mail address with "unsubscribe to bpt newsletter" in the subject line to info@ycst.com.

Members of the Business Planning and Transactions Section

Craig D. Grear, Partner. Mr. Grear has made numerous presentations nationally and internationally on a variety of Delaware business law topics, including alternative entities and Delaware holding companies. He is a 1989 graduate of Georgetown University Law Center.

cgrear@ycst.com
302.571.6612

James P. Hughes, Jr., Partner. Mr. Hughes has litigated numerous matters in the Delaware Court of Chancery and served as in-house counsel at an Internet company. He is a 1992 graduate of the University of Pennsylvania Law School.

jhughes@ycst.com
302.571.6670

John J. Paschetto, Partner. Mr. Paschetto has contributed to several books on corporate takeovers and the limitation of director liability. He is a 1998 graduate of Harvard Law School.

jpaschetto@ycst.com
302.571.6608

Norman M. Powell, Partner. Mr. Powell writes and speaks regularly at conferences and training programs on topics including alternative entities and secured transactions, and serves on the Commercial Financial Services, Legal Opinions, and Uniform Commercial Code Committees of the Business Law Section of the American Bar Association. He is a 1989 graduate of Villanova University School of Law.

npowell@ycst.com
302.571.6629