THE VALUATION LAW REVIEW

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Corporate / Securities Decisions and Certain Canadian Regulatory Developments

The Valuation Law Review summarizes corporate and securities decisions and recent regulatory developments of interest to business valuators and is a joint publication of The Canadian Institute of Chartered Business Valuators and Stikeman Elliott LLP. The Valuation Law Review is not intended to provide legal advice and readers should not act on information in the publication without seeking particular advice on matters that are of concern to them. Readers are cautioned against relying upon the decision abstracts contained herein, which are edited and in outline form only, and are directed to the full report of the reasons of the Court or Securities Regulator, as applicable.

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June 6, 2005
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June 22, 2005
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(2005) C. A. No. 20502
Court of Chancery, State of Delaware
April 29, 2005
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(2005) C.A. NO. 19598
Court of Chancery, State of Delaware
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(2005) C.A. No. 411-N
Court of Chancery, State of Delaware
March 4, 2005
Here, plaintiffs were found to be entitled to a quasi-appraisal where there had been a technical deficiency in the disclosure provided by the defendants in the context of a short-form merger. The quasi-appraisal was awarded because, had the disclosure been completed properly, a statutory appraisal would have been available to the minority shareholders. Where a statutory appraisal is no longer applicable but the court determines that the plaintiff is entitled to a remedy, the court has the discretion to define a quasi-appraisal approach. Vice Chancellor Lamb deduced that the opt-in and risk features of the appraisal statute as well as the approach of valuing the shares at their fair value at the time of the merger should be used as guidance for how to conduct the quasi-appraisal.

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I. CANADIAN CASES

Ford Motor Co. of Canada, Ltd. v. Ontario Municipal Employees Retirement Board et al.

Unreported

Court of Appeal for Ontario

January 6, 2006

Transfer pricing system that favoured U.S. parent found oppressive of minority shareholders of Canadian subsidiary. Ontario court reviews law of oppression in detail in the context of minority's dissent from Ford Canada's going-private transaction

Oppression and appraisal issues were at the heart of this important decision from the Court of Appeal for Ontario. Authored by Justice Rosenberg, the unanimous reasons are particularly significant in light of what they say about intercorporate financial arrangements between partly-owned subsidiaries and the companies that control them. The bottom line is that an affiliated company's board members must be vigilant in defending its interests as distinct from those of the parent company. Should they fail to ensure that intercorporate arrangements are fair to minority shareholders, both they and the controlling shareholder may face oppression claims.

The litigation arose from Ford Motor Co.'s 1995 attempt to take its 94%-owned Canadian subsidiary, Ford Motor Co. of Canada (Ford Canada), private. When some of the minority shareholders, led by OMERS, dissented, Ford Canada asked the court for a declaration regarding the fair value of their shares. The dissenters counterclaimed against Ford Canada and Ford Motor Co. (Ford U.S.), alleging that the companies' intercorporate financial arrangements had artificially depressed the value of Ford Canada at their expense.

At Issue: Ford's Transfer Pricing System

The transfer pricing system and other intercorporate arrangements (the TPS) were too complex to be easily summarized, but the general ground rules of the relationship between the Canadian Vehicle Division (CVD) and the U.S. Vehicle Division (USVD) suggest the nature of the problem. For example, (i) the CVD and USVD paid the same price for a vehicle whether manufactured in Canada or the U.S., (ii) prices were denominated in USD, (iii) the CVD had to pay the same prices (to other divisions in the company) that Ford U.S. had set for the USVD. In general, it appeared that Ford U.S. may have been dictating terms to Ford Canada that Ford Canada would have been unlikely to accept had it acted as an arm's length entity. In particular, the dissenters argued that Ford Canada unfairly bore currency risk and that the intangibles element of the TPS was unfairly allocated to the CVD.

Another point of considerable importance was that the court refused to allow Ford to balance any unfairness in the relationship between the two Vehicle Divisions against advantages held by other Canadian divisions, some of which had benefited from the decline in the value of the Canadian dollar that was behind much of the CVD's red ink. In addition to accepting the dissenters' argument in favour of this "division by division" analysis, the Court of Appeal accepted their preference for determining the fairness of the TPS by using a "profit-split approach" under which the overall profit of the vehicle divisions would be allocated according to their "assumed economic contributions to the economic unit".[1] On this basis, the average return on investment in Ford Canada was negative 23.5% over the 1985-95 period, as opposed to a positive ROI of 26.8% for Ford U.S.

In determining fairness, the key issue was whether Ford Canada would have agreed to the TPS if it hadn't been an affiliate of Ford U.S. The ROI figures and the details of similar relationships between the U.S. and Canadian divisions of GM and Chrysler (as well as Ford's own history of relationships with such genuine arm's length partners as Mazda) made it hard to argue that they would have.

Unfair Yes, But Oppressive?

That the TPS was unfair doesn't necessarily mean that it was oppressive, however. One of the most valuable aspects of the decision is the Court of Appeal's analysis of the elements of oppression. What is especially interesting is Justice Rosenberg's understanding of the fundamental nature of the oppression remedy as focused on the *effects* of corporate actions rather than on the intentions or states of mind of corporate actors. On this view, the oppression remedy appears to be primarily an economic rebalancing mechanism that is generally indifferent to questions of fault.

Ford raised four arguments against the oppression allegation, falling under the following headings: (i) the business judgment rule, (ii) the effects not being foreseeable to the company; (iii) shareholders' having had no reasonable expectation of being treated any other way; and (iv) with respect to the allegations against Ford U.S. only, the absence of a fiduciary relationship.

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1 Here the Court of Appeal is quoting from Anita I. Anand and Kim Brooks, "The Allocation of Profits Between Related Entities and the Oppression Remedy: An Analysis of *Ford Motor Co. v. OMERS*" (2005), Ottawa Law Review 36:1, 129 at 138. Ford had urged the court to use a "transaction method" under which the fairness of the TPS would be assessed on a transaction by transaction basis, but this was rejected, partly because of the number of transactions involved.

Business judgment rule

The business judgment rule is essentially a principle of judicial deference to the good-faith judgment of directors. It originated in the U.S. but has recently been gaining ground in Canadian jurisprudence as well. Here, the Court of Appeal agreed with the trial judge that Ford Canada could not take recourse to its business judgment because it had not exercised any judgment at all. The board had neither conducted an independent review of the TPS nor discussed it in any meaningful way. Indeed, the board had "little understanding" of the intercorporate arrangements, having instead "simply accepted the system that was put into place by Ford U.S." The court, singularly unimpressed, observed that the exercise of at least some judgment is a required before a company or a board can hope to take shelter under the business judgment rule.

While that aspect of the reasoning seems uncontroversial, the court also asserted that the business judgment rule will also not apply where directors have "unfairly disregarded the rights of a group of shareholders". Whether this is consistent with the Supreme Court of Canada's broad endorsement of business judgment in *Peoples Department Stores v. Wise* (2004), summarized in the April 2005 edition of The Valuation Law Review, needs to be considered.

Foreseeability

Consistently with its overarching view of oppression as concerned primarily with effects, the court held that under the CBCA there is no requirement that a company did foresee (or ought to have foreseen) the oppressive results of its actions in order for an oppression remedy to succeed with respect to those actions.

Reasonable Expectations

The Court of Appeal held that shareholders' reasonable expectations can be proved inferentially from circumstantial evidence, and in particular from the written and public pronouncements of the company. In other words, what a company says publicly may end up defining shareholders' reasonable expectations at trial. Here, a note to Ford Canada's 1978 financial statement had read "The Ford policy is that prices for products be negotiated on an arm's length basis by the affected organizations." This had been altered a few years later to read "The prices for items purchased or sold are calculated to approximate levels charged by

competitive sources for similar goods", but even in that case, Justice Rosenberg held, it was open to the trial judge to find-as indeed he had found-an implication that the company's policy was to work out intercorporate arrangements on an arm's length basis.

Fiduciary duty

When the dissenting shareholders attempted to broaden the oppression claim to include Ford U.S., the American parent argued that oppression could not be found because there was no legally recognized fiduciary duty between a corporation and the minority shareholders of its partly-owned subsidiary. The Court of Appeal held that the oppression remedy is broad enough to encompass situations in which no fiduciary relationship exists.

Can The "Parent" Be Blamed For The Subsidiary's Oppression?

The Court of Appeal's ruling on the shareholders' attempt to bring Ford U.S. into the action is significant. Overruling the trial judge on this point, the court held Ford U.S. liable under the CBCA oppression provision. Significantly, Justice Rosenberg came to this conclusion despite a failure to find that the minority had any reasonable expectations about the conduct of Ford U.S. It appears that the simple fact of Ford U.S.'s control of Ford Canada, and in particular its ability to change the TPS, was sufficient to bring it within the ambit of an oppression action by its fellow shareholders in the Canadian company. The court is clear, however, that Ford U.S. was not open to an oppression action merely because of its status as an affiliate of Ford Canada-the prerequisite appears to be a capacity to control the oppressive act.

Can You Recover For Oppression That Occurred Before You Acquired Your Shares?

This was one of the key issues in the case. At trial, the dissenters had tendered no evidence as to the dates on which they had purchased their shares. To say the least, this strategic decision backfired on them as the Court of Appeal held that it had no choice but to conclude that the shareholders had owned their shares for only one day.[2] Thus, the liability found against Ford U.S. and Ford Canada on the oppression issue attracted only a token amount of compensation.

2 The trial judge had proposed to allow the dissenters to prove their purchase dates at a separate special proceeding to be convened for that purpose, but the appellate judges held that there was no legal ground for such a generous approach.

The dissenters had a couple of fallback positions, however. The first of these is interesting even though it failed. The shareholders argued that as a matter of principle it didn't matter whether they had owned their shares at the relevant time or not. Their counsel noted that remedies ordered under the oppression remedy have frequently been directed to the benefit of the corporation as a whole, and as such have benefited all existing shareholders regardless of whether they were shareholders at the time of the oppression. The court responded that this happens only where a court orders an oppression remedy that benefits the corporation as such, and never where the *direct* beneficiaries of the proposed remedy are the shareholders themselves.

Perhaps reflecting its general philosophy of oppression as a form of economic rebalancing, the Court of Appeal also noted that retrospective recovery would not be compensatory and that, in addition, it would not be consistent with the doctrine that a shareholder's reasonable expectations "are the touchstone to entitlement to compensation for oppression".

Can "Pre-Acquisition" Oppression Figure Into "Fair Value" Under An Appraisal?

The dissenting shareholders had a second fallback position with respect to recovery for the oppression that preceded their ownership of the shares. Even if there could be no direct recovery for oppression, they argued, the fact of the oppression could still figure into the "fair value" calculation under the appraisal remedy. In other words, the fair value they received on disposing of their shares could be grossed up by the amount of value that was lost over the years as a result of the intercorporate arrangements.

The Court of Appeal didn't accept this. While it agreed that "fair value" for the purposes of the CBCA appraisal remedy is a more flexible concept than "fair market value", it held that a "fair value" valuation pursuant to a CBCA appraisal cannot be used as a back-door route around the limitations of the oppression remedy.

However, the court held that the fair value calculation can take account of oppression on a "going-forward" basis. That is to say, where there has been ongoing oppression, fair value should be based on the assumption that the oppressive activity will cease at the moment of sale (presumably whether or not this is true). In other words, while the fair value calculation cannot attempt to

rewrite history by valuing the company as though the oppression never happened, it can rewrite the future (so to speak) by valuing the company as though it were being sold to an arm's-length third party that had insisted that the unfair arrangement constituting the oppression-in this case the TPS-be ended.
The court also rejected the argument that fair value under the appraisal remedy could take the conduct of the company into account. This seems to be the correct view, although a few U.S. and Canadian cases on the subject have held otherwise. (For an example, see the summary of the British Columbia Supreme Court's *Anthem Works* decision elsewhere in this edition.)

The Result

The results were mixed. The dissenting shareholders received a significantly increased valuation under the appraisal remedy ($207 rather than $185 per share). The Court of Appeal rejected the dissenters' argument that they should have been awarded a figure at the high end of the experts' range of estimates, rather than at the midpoint. Rosenberg J.A. noted that the appraisal remedy recognizes the economic legitimacy of squeeze-out transactions and that to choose a value at the high end of the range would wrongly suggest that the law frowned on such transactions.

Despite some success on the valuation front, however, the shareholders received virtually nothing on account of the oppression, having failed to prove ownership of the shares during nearly all of the relevant period.

Nations Energy Company Ltd. et a1.
2005 ABASC 725
Alberta Securities Commission
August 19, 2005

Tartan Energy Inc, an oil and gas company based in Calgary, had adopted a shareholder rights plan (the "Plan") in response to an unwelcome take-over bid by Nations Energy Company Ltd. which was implemented the day before the take-over bid was due to close without shareholder approval or review. The Plan contained a poison pill triggered by a "flip in" event pursuant to which all of the shareholders other than Nations had the right to purchase securities from Tartan at a significant discount. This had the potential to significantly dilute Nations' proportionate shareholding, rendering the take-over less attractive economically.

The Alberta Securities Commission reviewed the appropriateness of a shareholder rights plan in the context of an unsolicited take-over bid.

Nations Energy applied to the commission for a cease trade order, whereupon Tartan applied for an order that Nations amend the disclosure in the bid circular in relation to various lock-up agreements that had been entered into, and to extend the bid.

The commission took the side of Nations on both counts.

Poison Pill

A shareholder rights plan, commonly known as a "poison pill", is a mechanism that is designed to provide a company subject to an unsolicited take-over bid with an adequate period of time to fully examine value-enhancing alternatives for the benefit of its shareholders.

After referring to National Policy 62-202 – Take-Over Bids – Defensive Tactics and to several key decisions on the appropriateness of rights plans such as *Re Royal Host Real Estate Investment Trust* and the laundry list of relevant factors set out therein, *Re Cara Operations Ltd*. and *Re Samson Canada Ltd*., the Commission determined that the fundamental question at issue was whether the best interests of the shareholders were served by the continued operation of the Plan, noting that the burden of proof (per *Samson*) lies with the target company. That question was answered in the negative and an order was granted "cease trading" the Plan. The Commission cited the following factors in its reasoning:

(1) The shareholders had not formally approved the Plan. Although informal expressions of shareholder support for the Plan might be taken into account in certain circumstances, in this case the informal support emanating mainly from management was discounted on the basis that management might have a vested interest in entrenching their position and seeing the bid defeated.

(2) Timing of the Plan was too tight. Management had been aware of the bid for some time and had chosen to implement the Plan at the last minute (one day before the bid was due to expire). In fact, at the time of the hearing, it had been 78 days since Nations had publicly announced its intention to make the bid. This pointed to a targeted effort at frustrating the bid as opposed to a bona fide effort to promote an auction process with a view to maximizing shareholder value.

(3) There were no other bids on the table at the time the Plan was adopted, nor were there any realistically in prospect. In this regard, the Commission noted their perplexity at Tartan's selection of August 1 as the deadline for competing offers, given the July 29 bid expiry date, and suggested that any serious potential competing bidder would likely have presented a proposal before then. The Commission was concerned that allowing the Plan would put the shareholders at risk of being deprived of the one bid available to them, given the pending expiration of Nations' bid, as Nations had declined to indicate at the hearing whether it intended or would be willing to extend the bid, and the Commission indicated it was not obliged to do so.

(4) There was no evidence that the bid contravened securities laws, or was unfair or coercive to Tartan shareholders which merited the continued operation of the Plan.

(5) There is a public interest element in ensuring the fairness and predictability of the take-over bid process. The Commission was of the view that sanctioning the Plan would undermine that predictability and fairness, creating a situation of confusion to the detriment of other market participants.

Disclosure Of Lock-Up Agreements

Tartan argued that the bid be extended on the basis that there had been insufficient disclosure of certain lock-up agreements in the bid circular (the description was one paragraph and took up less than a third of a page). The Commission disagreed with Tartan. Nations had not omitted or misstated material information, and there had been sufficient disclosure to allow investors to make an informed decision on whether to tender to the bid.

On December 15, 2005, the Court of Appeal for Ontario overturned the Superior Court's controversial ruling in the Danier Leather case. That 2004 decision had interpreted the statutory cause of action for misrepresentation in a prospectus to include the failure to disclose material facts arising in the period between the issuance of a prospectus and the conclusion of the distribution taking place under it.

Kerr et al. v. Danier Leather Inc. et al.

(2005), Doc. No. C41880 (unreported)

Ontario Superior Court of Justice

December 15, 2005

In this much awaited decision, the Court of Appeal for Ontario held that:

(1) Section 130 of Ontario's *Securities Act*, which creates this cause of action, does not expand the disclosure obligations set out in Part XV of the Act;

(2) An issuer does not have a continuing obligation to disclose material facts arising after the date of the prospectus and before closing of the distribution;

(3) A prospectus does not contain an implied representation that the included forecast is objectively reasonable; and

(4) Even where a prospectus is found to contain a representation about the objective reasonableness of the included forecast, courts should give significant deference to the business judgment of the issuer's senior management.

Background And Trial Court Decision

Danier, a manufacturer and retailer of leather clothing and accessories, conducted an IPO in May 1998. The final prospectus, issued May 6, included a forecast of Danier's projected revenue and earnings for the current quarter (Q4) of its financial year. One day before the May 20 closing date of the offering, an internal company analysis revealed that Danier's Q4 results were falling short of the levels on which the forecast was based. Danier issued a revised forecast disclosing the new information, but only after the closing of the offering. Its share price plunged on the news, but rebounded when the company's sales subsequently improved. In the end, Danier substantially achieved its original forecast for the quarter.

The plaintiff shareholders commenced a class proceeding on the basis that there was a misrepresentation in the prospectus, asserting that even if the variation between the forecasted sales amounts and Danier's actual results did not amount to a material change requiring the filing of an amendment to the prospectus, it was still a material fact that had to be disclosed under Section 130(1).

Section 130(1) creates a cause of action for misrepresentation in three cases. Specifically, where a prospectus (i) contains an untrue statement of material fact, (ii) omits a material fact that is required be stated, or (iii) omits a material fact that is necessary to make a statement not misleading in the light of the circumstances in which it was made. There is no requirement that shareholders prove that they actually relied on the misrepresentation.

After a lengthy trial, Justice Lederman held Danier and its chief officers liable, on the ground that the prospectus contained an "implied misrepresentation" that the Q4 forecast was objectively reasonable both on the date of issuance and on the date the offering concluded. The poor Q4 results were material facts, he held, and Danier had been required under Section 130 to disclose them before closing. He further concluded that since Danier had failed to disclose these material facts, the implied representation of the objective reasonableness of the forecast, while initially true, became false on the closing date because it gave a false impression to the market as of May 20, 1998. He held the fact that Danier's forecast was eventually vindicated to be essentially irrelevant.

Having found a breach of Section 130, the trial judge awarded damages, using the decline in Danier's share price that occurred after the disclosure of the revised sales figures as the prima facie measure of the damages award.

The Court Of Appeal Decision

The Court of Appeal considered four issues:

(1) The interpretation of the disclosure obligations imposed on an issuer in relation to a prospectus;

(2) The implied representation of objective reasonableness found by Justice Lederman;

(3) The effect of the business judgment rule; and

(4) The significance of the fact that Danier had substantially achieved its Q4 forecast.

Did Section 130 of the Securities Act require Danier to disclose material facts occurring in the period between the issuance of the prospectus and the closing of the offering?

The pivotal issue of the case was whether Section 130 could be interpreted as requiring disclosure of material facts arising in the period following the issuance of the prospectus. While that section might be interpreted this way in isolation, the Court of Appeal concluded that the clear intent of the Legislature had been to define disclosure obligations exclusively in Part XV of the Act. Part XXIII of the Act, which includes Section 130, was intended to set out the causes of action that

result from failures to meet those obligations. Justice Lederman had therefore erred in looking to Section 130 to resolve the issue in this case.

Part XV clearly sets out what the purchasers of Danier's shares were entitled to assume: (i) that its prospectus, including the forecast, provided full, true and plain disclosure of the all facts which may be expected to have a significant effect on the market price or value of Danier's securities and (ii) that, subsequent to the issuance of the prospectus, nothing that counts as a "material change" under the Securities Act had occurred. In other words, there had been no change in the business operations or capital of Danier that would reasonably be expected to have a significant effect on the market price or the value of securities between May 6 and May 20, 1998.

Because Part XV of the *Securities Act* constitutes a complete code for distributions to the public under a prospectus, the Court of Appeal concluded that Danier had no obligation to update its forecast by disclosing the quarterly results to the date of closing. In reaching this conclusion, the court relied on the use of "material change"[3] as the trigger to the disclosure obligation under Section 57(1) of the Securities Act, and the absence of a similar express obligation to disclose "material facts"[4]. The court stated that the Legislature had made a "policy choice" to require updates for material changes but not material facts.

Did Justice Lederman err in law in concluding that Danier's prospectus contained an implied representation that its forecast was objectively reasonable?

The court held that a reasonable person reading the prospectus would have concluded only that the prospectus represented management's best judgment, as the Danier prospectus said explicitly. Absent legislation deeming a forecast to carry an implied representation of objective reasonableness, Justice Lederman would have had to have found otherwise as a matter of fact, which he had not done.

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3 A material change is defined, in part, as "a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer."
4 A "material fact" has a broader meaning than material change and has been held to include "a fact that significantly affects, would be reasonably expected to have a significant effect on the market price or value of the securities.

Does the business judgment rule have been taken into account?

The Court of Appeal held that Justice Lederman erred by failing to give due deference to the business judgment of Danier's senior management. The business judgment rule, which originated in the United States but is now broadly recognized in Canadian law, provides that a court will defer to the business judgment of a company's directors where it is exercised reasonably and on an informed basis. Justice Lederman had therefore been obligated to consider whether senior management's honest belief in the forecast's achievability was "within a range of reasonable alternative opinions open to business people in their position, knowing what they knew and facing the circumstances they faced."

What is the significance of the fact that the actual final results were substantially in keeping with the forecast?

Finally, the Court of Appeal held that the trial judge erred by ruling that the actual financial results were immaterial to the analysis of whether the forecast was objectively reasonable. The court noted, to the contrary, that "the objective reasonableness of the predicted result of an experiment is perhaps best tested by conducting the experiment."

Lessons From Danier

This effect of this decision has yet to be determined, but it is likely that the practice that evolved among market participants of "bringing down" due diligence just prior to closing of a distribution will likely continue as a best practices approach to review for the occurrence of any material changes since the date of the final prospectus (or new material facts that might, individually or in aggregate, constitute a material change).

In addition, boards and management may take comfort in the further validation that the business judgment rule is alive and well in Canada. Provided that the board and the management adopt appropriate procedures and makes reasonable decisions, the courts will continue to give deference to those decisions even if they turn out in hindsight to be less than perfect.

Re Financial Models Co.

2 B.L.R. (4th) 223

Ontario Securities Commission

February 22, 2005

Here, the Ontario Securities Commission examined the inclusion of shares tendered pursuant to a take-over bid in the calculation of majority-of-minority approval of a second-step transaction. In addition, the Commission examined the availability of the exemption from the formal valuation requirement of Rule 61-501.

The proceeding was a hearing on an application by a Special Committee of directors of Financial Models Company Inc. ("FMC") for orders under ss. 104(1) and 127(1) of the *Securities Act* (Ontario), based on allegations that a take-over bid made on December 29, 2004 by 1066821 Ontario Inc.-the "Katotakis Holdco"-for all the shares of FMC was neither in compliance with the take-over provisions of the Act nor, more generally, in the public interest.

Facts

FMC, a closely held company, was authorized to issue an unlimited number of common shares and an unlimited number of Class C non-voting shares. Katotakis held approximately 40.4% of the shares. Dr. William R. Waters, together with William R. Waters Ltd., held about 20% of the shares and BNY Capital Corp. about 22.4%. FMC's minority shareholders were principally Van Berkom and Associates (6.7%), Triax Growth Fund Inc. (2.9%), as well as certain of FMC's senior executives (3.2%) and its directors and employees (roughly 3-4%).

On January 13, 1998, Katotakis, Waters, BNY and FMC Investment Services Ltd. entered into a Shareholders Agreement to manage their investment in FMC. The agreement gave each party rights of first offer and first refusal, under which a party willing to sell shares had to give the other parties a selling notice setting out the price at which the party is willing to sell (the "set price"). If the other parties accepted the selling notice, the selling shareholder would have to make a take-over bid for all shares at the set price (the parties accepting the selling notice being obliged to tender into that take-over bid). On the other hand, if the other parties did not accept the selling notice, the selling shareholder was free to sell his shares to third parties at the set price or higher.

In August 2004, Linedata Services S.A. of France discussed a possible business combination with Katotakis, acting on behalf of FMC, under which Linedata would acquire all of the shares.

A couple of months later, Katotakis told FMC's board of directors that he didn't want to continue the discussions with Linedata. John Vivash, FMC's chairman, and other members of FMC's board of directors (but not Katotakis) confirmed with Linedata their interest in pursuing the proposed business combination and formed the Special Committee to negotiate and pursue transactions likely to maximize shareholder value and shareholder liquidity in respect of FMC. By the end of

November, BNY, Waters, Van Berkom and Triax had agreed in principle with Linedata to tender their shares into a satisfactory offer by Linedata to acquire all the shares.

On December 8, 2004, Katotakis, concerned about the advancing discussions between the Special Committee and Linedata, delivered a requisition requiring FMC to call a shareholders meeting to remove all directors of FMC, other than himself. The board of directors called a shareholders meeting for May 2005.

The same day, BNY and Waters delivered selling notices to Katotakis stating their desire to sell all of their shares at a set price of $12.20 per share. Waters and BNY waived their rights to purchase each other's shares. The selling notices allowed for acceptance by Katotakis within 21 days of delivery.

On December 20, the Special Committee, on behalf of FMC, entered into an acquisition agreement with Linedata, while Waters, BNY, Triax and Van Berkom entered into soft lock-up agreements with Linedata. These agreements were expressly subject to Katotakis' rights under the Shareholders Agreement. Three days later, Linedata offered to buy all issued and outstanding shares for a combination of cash and Linedata shares. The imputed aggregate value was $12.76 per share.

On December 29, Katotakis purported to exercise his ROFR[5] , accepting the selling notices entitling him to acquire a further 42% of the shares of FMC, and, as required by the Shareholders Agreement, launched his own offer at the set price of $12.20 per share. The Katotakis offer contemplated a subsequent second-stage transaction if all shares were not acquired pursuant to the initial offer. It was contemplated that this "follow-on transaction" could consist in an amalgamation of FMC and a subsidiary of the Katotakis Holdco with shares not owned by Katotakis being cashed out. Such an amalgamation would require the approval of holders of at least two-thirds of the shares, including, under Rule 61-501, a majority of the shares held by minority shareholders.

To complicate maters further, Linedata increased its offer to $14.65 per share upon learning that another bidder was contemplating a competing offer. While not a significant issue in the OSC proceedings, the increased bid was of importance in the subsequent Superior Court and Court of Appeal hearings.

5 The validity of this acceptance was contested in a separate proceeding before the Ontario courts, discussed immediately following this summary.

The Katotakis Offer contemplated that shares acquired by Katotakis from Waters and BNY would be counted in determining minority approval for an amalgamation.

Positions Of The Parties

Among other things, counsel for the Special Committee asserted that:

(1) It was contrary to the public interest and abusive of the capital markets for Katotakis to treat, for the purposes of Rule 61-501, the shares that would be acquired pursuant to his purported acceptances of the selling notices under the Shareholder Agreement as part of the majority of the minority in calculating the threshold under the follow-on transaction;

(2) Katotakis' reliance on the valuation exemption in para. 4 of Section 2.4 of Rule 61-501 would abuse that exemption;

(3) By his conduct, Katotakis had acted in a manner contrary to the public interest by engineering a result that deprives FMC shareholders of the opportunity to obtain full value for their shares through a competitive bidding process.

In reply, counsel for Katotakis argued that:

(1) There was nothing abusive about Katotakis' conduct. First, none of the transactions provided for were "artificial". Secondly, a follow-on transaction would not circumvent the reasonable assumptions or justifiable expectations of FMC shareholders;

(2) The Katotakis offer was not unlike any other take-over bid where a significant shareholder had entered into a lock-up. In those circumstances, it is quite customary for the offer to be followed by a follow-on transaction at the price paid to the locked-up shareholders;

(3) The Katotakis offer complied in all technical respects with Rule 61-501, which was adopted in its current form after a public comment process where the issue of whether locked-up shares should be counted as minority shares in calculating thresholds in a follow-on transaction was decided in the affirmative.

Analysis

Minority Approval

Section 104(1) of the Act provides for the imposition of an order by the Commission requiring an amendment to any document used in connection with a take-over bid and directing any person to comply with the Act where the person is not or has not complied with the Act.

The Commission found that Katotakis had complied with Section 8.2 (the "minority approval" provisions applicable to second-stage transactions) of Rule 61-501. Because Section 104(1) can be invoked only in the event of non-compliance, it therefore did not apply here.

The Commission then examined Section 127(1) of the Act which provides, in part, that the Commission may make an order that trading in any securities by or of a person or company cease permanently or for such period as specified in the order if in its opinion it is in the "public interest" to make the order or orders:

The Commission held that orders in the public interest under Section 127(1) of the Act could be appropriate when there is abuse. The Commission considered *Canadian Tire Corp. v. C.T.C. Dealer Holdings Ltd.* (1987), adopting the following reasoning from that Court of Appeal for Ontario decision:

> To invoke the public interest test of Section 123 [now Section 127], particularly in the absence of a demonstrated breach of the Act, the regulations or a policy statement, the conduct or transaction must be clearly demonstrated to be abusive of shareholders in particular, and of the capital markets in general. A showing of abuse is something different from, and goes beyond, a complaint of unfairness. A complaint of unfairness may well be involved in a transaction that is said to be abusive, but they are different tests. Moreover, the abuse must be such that it can be shown to the Commission's satisfaction that a question of the public interest is involved. That almost invariably will mean some showing of a broader impact on the capital markets and their operation.

The Commission found that no facts or evidence before it suggested any artificiality to the various transactions, nor any intention or engineering by Katotakis to defeat the reasonable expectations of the shareholders.

In the absence of abuse, the Commission found that it is neither practical nor fair for the Commission to enter into an analysis of the personal reasons for shareholders to carry out transactions in their shares, and to use that analysis as a basis for overriding the clear provisions of a Commission rule. A desire to be free of a contractual commitment (such as that found in the Shareholders Agreement) is not a basis to invoke the jurisdiction of the Commission.

The Valuation Exemption

Section 2.4(1) of Rule 61-501 outlines exemptions to the requirement that a bidder who is an insider of the target company obtain an independent, formal valuation of the target's shares:

(1) Section 2.3 [the requirement for a formal valuation] does not apply to an offeror in connection with an insider bid in any of the following circumstances:

4. Auction - If

(a) the insider bid is publicly announced or made while

(i) one or more formal bids for securities of the same class that is the subject of the insider bid have been made and are outstanding, or

(ii) one or more proposed transactions are outstanding that:

(A) are business combinations in respect of securities of the same class that is the subject of the insider bid, or

(B) would be business combinations in respect of securities of the same class that is the subject of the insider bid, except that they come within the exception in paragraph (e) of the definition of business combination.

and ascribe a per security value to those securities,

(b) at the time the insider bid is made, the offeree issuer has provided equal access to the offeree issuer, and to information concerning the offeree issuer and its securities, to the offeror in the insider bid, all offerors in the other formal bids, and all parties to the proposed transaction described in clause (a)(ii), and

(c) the offeror, in the disclosure document for the insider bid,

(i) includes all material information concerning the offeree issuer and its securities that is known to the offeror after reasonable inquiry but has not been generally disclosed, together with a description of the nature of the offeror's access to the issuer, and

(ii) states that the offeror does not know, after reasonable inquiry, of any material information concerning the offeree issuer and its securities other than information that has been disclosed under clause (i) or that has otherwise been generally disclosed.

Counsel for the Special Committee argued that the Commission had held in *Re Orsini* (1991) that in determining whether the public interest had been contravened, it ought to consider whether a respondent has sought to rely on an exemption in a manner that is abusive of that exemption. In addition, counsel for the Special Committee referred to the OSC decision in *Re Maple Leaf Sports & Entertainment Ltd*. (1999), which held that requirements for disclosure of sufficient information to allow investors to make informed choices represent a fundamental underpinning of the regulation of the capital markets by the Commission.

The Commission considered these two decisions and found that, as an insider, Katotakis had been under no obligation to apprise shareholders of his "beliefs and expectations" about share value. It also found that the exemption did apply to the Katotakis Offer, for the following reasons:

(1) At the time the Katotakis Offer was publicly announced on December 29, 2004, the Linedata Offer for the same securities was outstanding;

(2) FMC had provided equal access to information to both Katotakis and Linedata; and

(3) Katotakis disclosed in its take-over bid circular that it had no knowledge of any undisclosed material fact with respect to FMC.

Counsel for the Special Committee argued in vain that recourse could be taken to the exemption only where an auction had taken place, noting that the word "auction" is used in the heading that precedes the exemption. The Commission responded that Ontario's *Interpretation Act* provides that headings in a statute are for convenience only and should not be considered in interpreting the meanings of the sections to which they apply.

Finally, the Commission stated that, notwithstanding its decision, minority shareholders are given rights in a follow-on transaction to be paid fair value for their shares through dissent rights.

Katotakis et al. v. William R. Waters Ltd. et al.
1 B.L.R. (4th) 168
Court of Appeal for Ontario
February 23, 2005[6]

The background of this case is set out in our preceding note on the related OSC hearing. The issue here was whether BNY and Waters could sell their shares to Linedata for $14.50 per share or whether they were bound by the terms of the shareholders agreement to sell to Katotakis at the "set price" of $12.20 per share.

To review the key facts briefly:

1. Most of the shareholders of FMC, including BNY and Waters-but excluding Katotakis-had negotiated draft acquisition and lock-up agreements with Linedata at an imputed aggregate value of $12.76 per share;

2. Pursuant to the ROFR in the shareholders agreement, BNY and Waters delivered selling notices to Katotakis-with a set price of $12.20 in cash-in which they incorporated the draft acquisition and lock-up agreements by reference;

6 With reference to the prior Ontario Superior Court of Justice decision, reported at (2005), 2 B.L.R. (4th) 71.

3. Katotakis purported to accept the selling notices and thereby agreeing to purchase the shares held by BNY and Waters at a price of $12.20 per share and on the same day launched a take-over bid to acquire all of the outstanding FMC shares other than those held by him at $12.20 cash per share;

4. The take-over bid by Katotakis included a funding commitment that provided the lender (ABRY) with discretion to determine whether the other conditions of the financing had been met;

5. Linedata then made its second and higher offer at $14.50 per share, which BNY and Waters considered to be a "superior proposal" under the incorporated draft agreements, and thereby BNY and Waters took the position that they were free to sell to Linedata at $14.50 per share unless Katotakis matched the higher offer;

6. Katotakis took the position that the superior proposal provision did not apply to his earlier exercise of a ROFR under the shareholders agreement-at which point the deadlocked parties headed to court.

On the initial application, Mr. Justice Ground of the Superior Court ruled against Katotakis' attempt to enforce his purported acceptance at $12.20 per share by finding that BNY and Waters were not contractually bound under the shareholders agreement to sell their shares to Katotakis at $12.20 per share. In his decision, Mr. Justice Ground reasoned that: (1) the discretion provided to the lender under the funding commitment vitiated the acceptance by Katotakis of the offer by BNY and Waters and (2) a "superior proposal" clause incorporated by reference in the draft acquisition and lock-up agreements were applicable to the Katotakis purported acceptance of the BNY and Waters offer even though such a clause went beyond what was expressly contemplated in the ROFR in the shareholders agreement. The second of these findings was upheld at the Court of Appeal, which accordingly saw no need to express an opinion on the first.

The Funding Commitment Letter

Ground J.'s holding on the funding commitment issue is of some practical significance. Section 96 of Ontario's Securities Act requires that "adequate arrangements" have been made in advance to fund a take-over bid. In Ground J.'s view, the funding commitment, with its language reserving discretion to the

lender, did not demonstrate the existence of "adequate arrangements". That term, he noted, "has been interpreted to mean that there must be accurate, clear and unequivocal assurance that the financing is in place" such as would give a public shareholder an unequivocal assurance that the funds are available. Importantly, even though it appeared that the wording had not been intended to give the lender more than the usual right to be consulted, and even though OSC approved wording was later retroactively substituted, Ground J. held that what mattered for purposes of Section 96 was the form of language used as of the time of the launch of the bid. As a result, he held, Katotakis' acceptance was invalid and could not create a binding obligation on the part of BNY and Waters to sell their shares to him.

It should be noted that as a result of to this case, the OSC adopted Rule 62-503 to try to address the uncertainty regarding the law relating to bid financing conditions. A summary of Rule 62-503 is provided below.

The Superior Proposal Provision

Writing for the Court of Appeal, Mr. Justice Sharpe focused on the second issue, ultimately upholding the lower court's ruling that the superior proposal clauses in the incorporated agreements applied and thereby rejecting the argument of Katotakis that he was entitled to specific performance of the initial offer to sell at $12.20 per share.

While acknowledging the vagueness of some of the terms in the agreements at issue, Sharpe J.A. noted that Katotakis had not objected to the selling notice's statement that the offer was made expressly under terms "substantially in accordance" with those of the draft deal with Linedata "to the extent applicable" to Katotakis. In the court's opinion, it was open to the application judge to interpret this as including the superior proposal conditions.

This was particularly so given the "commercial practicalities of the situation". Everyone involved knew that Linedata was in hot pursuit of FMC and was likely to up its bid in response to an acceptance by Katotakis. It was equally obvious-not least from the existence of the superior proposal clause itself-that Waters and BNY were interested in maximizing the price paid for their shares. Finally, the court noted that a finding in favour of Katotakis would mean that he could reap all the benefit of the increased offers.

While one might have argued that the ROFR contemplated a "set price" and that the shareholders agreement contained no "superior proposal" language, Sharpe J.A. observed that the shareholders agreement did permit the seller to include "any other terms and conditions that were not contrary" to the ROFR provision. As the superior proposal provision could hardly be said to contradict anything in the shareholders agreement-although it certainly supplemented it-there was clearly no reason that it couldn't be added. Katotakis' counsel referred to GATX Corp. v. Hawker-Siddeley Canada Inc., the 1996 Ontario decision overturning a complex series of transactions that had arguably been contrived to bypass a ROFR, but Sharpe J.A. distinguished that well-known ruling on the ground that no such monkey business had occurred here: incorporating the superior proposal condition preserved the essential element of a ROFR-Katotakis' right to have the final word.

Re Anthem Works Ltd.
5 B.L.R. (4th) 289
British Columbia Supreme Court
May 31, 2005

This ruling could make life harder for those who try to take advantage of a going-private transaction by purchasing shares in order to profit by exercising dissent rights. It suggests that their valuation issues may be resolvable only by a full-blown trial and that the valuation they receive could potentially be discounted because of the opportunism of their investment.

Valuation of shares bought specifically to take advantage of dissent right can differ from valuation of other shares, B.C. judge rules. Complexity of valuation issues requires converting dissenters' petition under Section 190 of the CBCA into a full-scale trial.

Anthem Works is a former TSX listed company that successfully went private in 2004. The offer of $14.50 fell within the range of $14.31 to $18.22 in the Valuation and Fairness Opinion (given by Raymond James) and it achieved a 97.9% take up, including 95.1% of minority shareholdings. Even though it was at the low end of the range, it represented a premium of 16-22% over the market price on the TSX depending how you measured it.

The dissenters (at least those involved in the current hearing) were opportunistic buyers-that is, they had apparently bought their shares after the going-private transaction was announced in the hope of profiting through the exercise of their dissent rights. They launched a petition under Section 190 of the CBCA to commence shareholder dissent proceedings. Anthem Works applied under the B.C. Rules of Court to have the petition converted to an action. That is the issue that was decided here-in favour of Anthem Works, as it turned out.

The dissenters argued that valuation was the only issue and that it could be handled by a petition through the filing of expert opinions-exactly the sort of efficient process the CBCA encourages, they noted. Anthem, on the other hand, argued that the valuation was not only complex but could potentially be affected by the lack of bona fides of the opportunistic dissenters. The dissenters strongly rejected this, arguing that the CBCA does not permit individualized assessment of the value of shares. In the alternative, they argued that even if the matter was more complex than they claimed, there was still no need for a full-scale trial.

Can Fair Value Be Different For Different Dissenting Shareholders?

Justice Davies' answer to the first question, surprisingly, was "yes". The dissenters cited a whole range of cases in which Canadian courts had held that opportunistic shareholders are just like any other shareholders when it comes to the exercise of rights such as the dissent and appraisal right. *Silber v. Pointer Exploration Corp*., an Alberta decision, was typical, stating that:

> …it would be impractical and unworkable for the court to inquire into every dissenting shareholder's state of mind. Moreover, shareholders are entitled to be motivated by the chance of making a profit.

In response, Anthem's counsel noted that these cases were mostly about standing, not valuation, and that case law firmly establishes that valuations under Section 190 are conducted on the basis of both legal and equitable principles. It would therefore be perfectly legitimate, he argued, to take their conduct into account in assessing their reasonable expectations about the value of their shares.

Davies J. accepted Anthem's argument that a judicial determination of fair value in dissent proceedings is not a "mechanical" application of "rigid formulae", being instead "an exercise of judgment that involves consideration of all of the circumstances as well as equitable principles." He also concluded, crucially, that

> …no court has definitively determined that the conduct of any dissenting shareholder is irrelevant to the determination of the fair value of that shareholder or group of shareholders' shares under the provisions of Section 190 of the CBCA.

Although several cases had stated that "motive" was irrelevant, Davies J. held that the issue here was "conduct". (Note, however, that the contrary view has subsequently been advanced by the Court of Appeal for Ontario in Ford v. OMERS, discussed elsewhere in this edition.)

Are Full Pre-Trial Procedures And A Trial Required?

Having determined that valuation was potentially a complex issue, Davies J. had to decide whether a trial was required. The dissenters argued that the existence of Section 248 of the CBCA, allowing summary dispositions of the rights of dissenting shareholders, strongly suggested that Parliament intended dissent issues to be heard in chambers by way of affidavit evidence (with experts available for cross-examination, if necessary).

Davies J. reviewed case law stating that summary proceedings are the "default" mechanism and are not necessarily ruled out by the existence of "some disputed facts". He decided that the petition should be converted for a number of reasons, including the need to assess the credibility of witnesses, the complexity of the issues, the complexity of valuations generally, and the fact that the dissenters themselves had wanted to include "interviews" with Anthem's officers and auditors, as well as with Raymond James, as part of the petition process. In light of this, a trial was ordered.

Davies J. added that in some ("and perhaps even most") cases courts might well be able to fairly value dissenters' shares by means of a petition. That was not the case here, however.

Enterprise Payment Solutions Inc. et al. v.
Soft Tracks Enterprises. Ltd. et a1.
2005 BCSC 572
British Columbia Supreme Court
April 15, 2005

Enterprise Payment Solutions Inc., 574073 B.C. Ltd., and Ms. Juliana Cafik applied as dissenting shareholders for an order compelling Soft Tracks Enterprises Ltd. to purchase their shares for $172,500. The company claimed that the purchase price for all of the shares should be the nominal sum of $1. The petitioners exercised the right of dissent in relation to a special resolution presented to shareholders for the purpose of procuring agreement to the sale of the company's assets.

Soft Tracks Enterprises-which we will refer to as "New Soft Tracks"-was incorporated as a numbered company for the purpose of acquiring the business assets of a company also named Soft Tracks Enterprises Ltd. Old Soft Tracks was engaged in a software development business.

Until December 2003, the issued shares of Old Soft Tracks included 72,918,562 common shares and 35,915,067 preferred shares. The paid-up capital of all preferred shares was $1,270,000. The petitioners owned common shares of Old Soft Tracks.

In December 2003, Old Soft Tracks, in an effort to permit the use of its losses for income tax purposes, incorporated the numbered company to acquire Old Soft Tracks in exchange for common and preferred shares, the number and paid-up capital of which would be identical to the number of issued Old Soft Tracks common and preferred shares. The holders of preferred shares of Old Soft Tracks then agreed to convert their Old Soft Tracks preferred shares into common shares of Old Soft Tracks so that they lost their preference. Following the conversion, 45% of all common shares of Old Soft Tracks were sold by shareholders pro rata to ARC Financial Ltd. for a little over half a million dollars.

The numbered company then adopted the Soft Tracks name and carried on the previous Soft Tracks business. No sooner had all this happened, however, than New Soft Tracks turned around and entered into an agreement to transfer all of its assets to IP Applications Corp. for consideration of approximately $690,000, all of which went to the preferred shareholders. The transaction required the approval by special resolution of New Soft Tracks shareholders, which was granted on January 27, 2004.

On January 25, each of the petitioners had provided New Soft Tracks with notice of dissent advising that each of them may require the company to purchase all of their shares in accordance with the *British Columbia Company Act*. On March 12, New Soft Tracks advised that it had determined the fair market value of the shares on the day before the resolution was adopted: zero. The petitioners were each sent a cheque for $1 for their trouble.

The Main Issue

Section 207 of the Act provides, in such a situation, a dissenting shareholder with the right to apply to the court to set the price and terms of the purchase and sale. The Act further provides that the price that must be paid to a dissenting shareholder for the shares is their fair value as of the day before the date on which the resolution was passed, including any appreciation or depreciation in anticipation of the vote on the resolution.

The petitioners claimed that the sale of the New Soft Track assets in the IP Applications transaction was improvident and made at an undervaluation. The petitioners also claimed that all shareholders should share in the sale proceeds. New Soft Tracks replied that the holders of preferred shares were entitled to the return of their aggregate paid-up capital of $1,270,000. The rights and restrictions attaching to shares specified that in the event of the sale, lease, assignment, transfer, conveyance or disposal of all or substantially all of the assets of the company, each holder of a preferred share would be entitled to call for a return of preferred share capital.

The petitioners claimed that because the value of the common shares must be determined on the day preceding adoption of the special resolution, the preferred shareholders could not have acquired their right to a preferential return of their paid-up capital.

Analysis

The court held that, although the triggering event had not occurred by the day before the resolution was passed, the fact that it was about to happen could not (and would not) be ignored a hypothetical purchaser of the common shares. The overall effect of the rights attaching to the preferred shares was that those who held them were entitled to recover their paid-up capital and, as the proceeds to be received on the sale were substantially less than the paid-up capital, no amount was available for distribution to the common shareholders.

The Secondary Issue

The other aspect of the petitioner's claim was that if the IP transaction were ignored, the value of the common and preferred shares in aggregate (based upon a valuation obtained in connection with the ARC transaction) would be $2.5

million, with the amount payable to common shareholders being $1.23 million. The petitioners would, based on this valuation, be entitled to $125,540.
Analysis

The court held that the estimate of $2.5 million could not be relied upon as a reasonable measure of the New Soft Tracks business, as it was a valuation that had not been exposed to the open market. In further support of this valuation, the petitioners pointed to the fact that the transfer of assets from Old Soft Tracks to New Soft Tracks in anticipation of the ARC Financial transaction occurred at a price of $1,568,999. The court found that this transaction could not be regarded as providing reliable confirmation of fair value as it was a non-market transaction between parties that did not deal at arms' length. The court also concluded that, as the consideration was securities rather than cash, the purchase price was less indicative of value.

Finally the court found that the valuation, having been prepared without the assistance of valuation experts, was not reliable.

Resolution

The court therefore fixed the total price for the purchase of all shares of New Soft Tracks owned by each petitioner at $1 and dismissed their claims.

Munrealty Inc. v. Ideal Construction Co. Ltd.

2005 CanLII 31993

Ontario Superior Court

September 7, 2005

Court denies leave for derivative action where shareholder can't show that company acted against its economic interests in not dissenting from 50%-owned subsidiary's sale of its only asset. Court also holds that previous offers for the asset are relevant to valuation of the subsidiary's shares.

This dispute arose in the context of a closely-held family company. Four cousins, through personal holdcos, each owned 25% of the company (Ideal). Ideal, in turn, owned 50% of Normill, a holding company whose only asset was an industrial building under a long term lease. One of the cousins (actually, her holding company, Munrealty) sought leave under Section 246 of the OBCA to force Ideal to exercise its dissent rights against Normill with respect to Normill's recently concluded sale of the industrial building. The case raised several issues relating to derivative actions and dissent rights.

The Facts

The facts and events were as follows: (i) the building's tenant of 45 years had announced that it was leaving mid-lease; (ii) Normill offered it for lease without success; (iii) Normill offered it for sale, receiving five unsatisfactory offers; (iv) Normill agreed to sell it to a sixth bidder that made a much better offer ($2.475 million); (v) the agreement of purchase and sale was conditional on shareholder approval by Normill; (vi) a notice of shareholders' meeting was delivered that didn't state that shareholders had dissent rights (and was defective in a few other respects); (vii) Ideal's shareholders met and the cousins split 2-2 over the sale; (viii) at the Normill meeting, the deadlocked Ideal didn't vote; (ix) the other 50% shareholder voted in favour and the deal was accordingly approved; and (x) the existing tenant agreed to pay Normill $100,000 to get out of the lease.

Before turning to the legal analysis, Justice Hoy found one further significant fact. The $2.475 million sale price was significantly higher than the most optimistic valuation of the property based on its rental value.

Positions Of The Parties

In spite of this, Munrealty wanted to bring a derivative action (or, in the alternative, an oppression action) against Normill, on the following grounds.

(1) The defects in the notice of the shareholders' meeting.

(2) Smith, one of the cousins who favoured the sale, was a director of both Normill and Ideal.

(3) Normill and the tenant used the same real estate agent (the tenant, it alleged, had no interest in Normill's achieving a high sale price for the property).

(4) At $100,000 the surrender payment negotiated by Normill and the tenant was too low (and allegedly would have been higher they not used the same real estate agent).

(5) The property was sold for less than its value (as supposedly evidenced by its having sold for $300,000 less than the asking price).

Obviously, a hearing on a leave application can't resolve the issues of the case. Thus the standard in Section 246(2) of the OBCA (and in similar sections of the CBCA etc.) is a fairly liberal one: the applicant must be acting in good faith and the proposed derivative action must "appear to be in the best interests of the corporation".

Counsel for Ideal argued that it had not needed to be told of its dissent rights, that individuals representing 75% of the beneficial interest in Normill favoured the sale, that the sale was on favourable terms, that the other shareholders in Normill were business partners of the Ideal shareholders in other ventures, and that exercising dissent rights would just make the lawyers rich. None of this, he argued, suggested that Ideal stood to benefit by exercising its right of dissent.

Analysis

Justice Hoy agreed, rejecting each of Munrealty's arguments (in doing so she also rejected the oppression claim). Particularly significant was her finding on the valuation issue. She rejected an argument that the fair value of the shares should be determined without regard to the lower arm's-length offers for the sole asset received prior to the successful offer. She distinguished the case cited by Munrealty – *Smeenk v. Dexleigh Corp*. (1990) – as holding only that events after the shareholders' resolution are irrelevant to determination of fair value. In addition, the fact that the building sold for $300,000 under the asking price was irrelevant to the question of fair value.

Hoy J. held that there must be at least some evidence that the issue of an undervaluation is arguable before leave could be granted for a derivative action to enforce dissent rights. Having failed to find any evidence of an undervaluation (and considerable evidence to the contrary-including the previous lower offers), she was unmoved by Munrealty's contention that leave could be granted simply on the basis of improprieties in the process, notably the fact that one cousin who had favoured the sale was a director of both Ideal and Normill (as was one cousin who'd opposed it).

A larger issue lay behind all of this, however. Can a derivative action be brought to force the exercise of a corporation's statutory or contractual rights, such as dissent rights? Normally, derivative actions force the company to recover property or otherwise enforce rights that the board, for whatever reason, has

failed to enforce. Counsel to Munrealty could cite no case in which a derivative action had been brought to force a company to exercise a statutory or contractual right. The distinction seems to be that the exercise of a statutory or contractual right tends to call for the board to exercise discretion and judgment in light of its understanding of the corporation's interests. Hoy J. therefore questioned whether permitting derivative actions to force a company to exercise such rights would be too great an incursion on the business judgment rule, although she didn't pronounce with any finality on the issue.

II. U.S. CASES

Re The Walt Disney Co. Derivative Litigation
(2005) Cons. C.A. No. 15452
Court of Chancery, State of Delaware
August 9, 2005

Directors held not to be liable for breach of fiduciary duty in sanctioning a massive executive compensation and severance package for the departing president after only 14 lacklustre months in the job.

Although directors should be reassured by this important reaffirmation of the business judgment rule, this case reminds us that the board must be willing to think for itself, ask more questions, and actively monitor management decisions, all of which should be buttressed by accurate and well-documented minutes and process.

This important Delaware decision reaffirms the business judgment rule as a safety net for directors who act diligently and in good faith. At the same time, however, the judge's criticism of the actions of the Disney board is indicative of closer scrutiny and the evolving attitude towards corporate responsibility in the post-Enron era.

This case concerned alleged breaches of fiduciary duty by Disney's directors in hiring, and little more than a year later, terminating the services of Michael Ovitz as president of the company. It was brought by disgruntled shareholders who were struggling with the notion that after 14 unsuccessful months as president of the company, Mr. Ovitz was packed off with an extremely lofty severance package (some estimates are as much as $140 million).

Mr. Ovitz was hired following the unexpected death of the Disney president in a helicopter crash, and the subsequent illness of the CEO, Mr. Eisner, who was an old friend of Mr. Ovitz. After months of personal negotiations between Mr. Eisner and Mr. Ovitz, the compensation committee of Disney approved the terms agreed between the two men after a very perfunctory review, whereupon the board of directors voted to elect Mr. Ovitz as president.

Within a short period of time it became clear to Mr. Eisner that Mr. Ovitz was not right for the job. This culminated in the no-fault termination of Mr. Ovitz, the terms of which were very lucrative. The termination was instigated by Mr. Eisner, and neither the board nor the compensation committee were consulted in any material sense, nor were they called upon to approve it. The board had been taken on what Chancellor Chandler described as a "wild ride", most of which "was in the dark."

Despite glaring deficiencies in the processes of the board, however, the court held that the directors had not betrayed the shareholders in hiring Mr Ovitz, nor did the generous severance package constitute a "waste" of corporate assets. The decision was hardly a vindication though: although the board was off the hook, Chancellor Chandler was extremely critical of its practices which in many respects fell "significantly short of the best practices of ideal corporate governance". To that extent, this case serves as a catalogue of what not to do if

you want to keep out of trouble as a director, and clarifies the legal standards to be applied to the actions of directors.

Business Judgment Rule Reaffirmed

Chancellor Chandler regarded the decision to hire Mr. Ovitz as a business decision which was to be examined through the lens of the business judgment rule. The business judgment rule operates as a presumption that directors have made an informed business decision in the honest belief that it is in the best interests of the company. The presumption is rebutted if there is evidence of fraud, bad faith or self-dealing.

At the outset, the court confirmed that the business judgment rule was alive and well: its protection underscores the premise that the "essence of business is risk", and it is not the role of the court to attempt to second-guess ill-conceived or unsuccessful business decisions other than to ensure they are subjectively made in good faith and in the best interests of the shareholders.

Breach Of Fiduciary Duty

The fiduciary duties owed by the directors of a Delaware corporation are the duties of care and loyalty, liability for which was assessed by the court on a director-by-director basis (departing from the approach in *Smith v. van Gorkom* where the conduct of the board was assessed as a whole). In assessing the actions of each defendant, the court concluded that none of them had breached their duty of care or loyalty, or acted in bad faith.

A breach of duty of care, according to the court, arises if the directors are grossly negligent in carrying out their office, which was defined by the court as acting in "reckless indifference" to or with "deliberate disregard" for the stockholders. The duty of loyalty, on the other hand, requires that the best interests of the company and its shareholders are paramount when decisions are made.

Notwithstanding that each of the directors were absolved from having acted in breach of fiduciary duty, Chancellor Chandler was strongly critical of Mr. Eisner who had orchestrated events by taking the decision to hire and then fire Mr. Ovitz largely into his own hands. Although others were involved in negotiating the final nuts and bolts of the arrangement, he had called the high level shots.

While he had not actively circumvented the correct decision-making channels, he had taken advantage of the fact that this was a board which was extremely deferent and acquiescent to his demands, a board which was apparently not in the practice of critically evaluating his decisions as CEO. That notwithstanding, the judge felt that Mr. Eisner had acted in the subjective belief that hiring Mr. Ovitz was in the best interests of the company, and he was therefore not in breach of his fiduciary duty.

In considering the claims against members of the compensation committee, Chancellor Chandler noted that although the committee had not reviewed the actual terms of the employment contract nor actively sought the advice of an executive compensation expert, it did have the benefit of a term sheet which broadly scoped the contractual arrangements, and an oral presentation in support delivered by the chair of the committee. Much was made of the hurried decision-making process of both the committee and the board, a process which had also been very poorly documented rendering it exceedingly difficult to evaluate. Despite the obvious deficiencies, however, Chancellor Chandler concluded that the board and the committee were sufficiently appraised of material on which to base a decision.

In response to the plaintiffs' argument that the decision to hire Mr. Ovitz had been made after insufficient deliberation, the Chancellor distinguished the landmark Delaware decision of *Smith v. van Gorkom* where the directors were held liable for approving the entire sale of the company without adequately considering key material information. In making an assessment in this context, the Judge said, one must compare the relative "orders of magnitude" of the decision itself. The sale of the entire company in the *van Gorkom* case had a far greater relative impact on the company than the hiring of Mr. Ovitz had on Disney, notwithstanding the "breathtakingly" generous terms.

Chancellor Chandler went on to consider whether passive indifference of the board constituted a breach of the board's fiduciary duty, holding that while best practice would of course dictate that the board do more to inform itself than it did, applying "aspirational" standards of corporate governance to a situation (which in this case was ten years before the increased vigilance triggered by Enron) would be "misplaced". Although clearly troubled by the board's actions, Chancellor Chandler held that there was no breach of fiduciary duty as measured by the corporate governance standards of the time.

In considering whether the directors were in breach of their fiduciary duty in respect of Mr. Ovitz's termination, Chancellor Chandler concluded that since the power to terminate had been delegated to Mr. Eisner in the by-laws and charter of the company, the Disney board was not obliged to act and therefore was not in breach of fiduciary duty by not having done so, regardless of the fact that Mr. Ovitz stood to receive such a large severance package as a result.

Independent Duty Of Good Faith

The court focussed on Delaware's good faith standard for fiduciaries and the thorny question of whether a separate duty of good faith exists in addition to a duty of care and duty of loyalty. The answer to this issue has significant ramifications since the corporate statutes of most companies preclude the indemnification of directors and officers if they fail to act in good faith. Although Chancellor Chandler stated that the duty of good faith is part and parcel of the duty of loyalty, he also raises the possibility of an independent duty of good faith by indicating that in addition to due care and loyalty, the duty of good faith requires a "true faithfulness and devotion to the interests of the corporation and its shareholders".

In re Cox Communications, Inc. Shareholders Litigation
(2005) Cons. C.A. No. 613-N
Court of Chancery, State of Delaware
June 6, 2005

This decision addresses the issue of non-meritorious, premature suits attacking negotiations in the context of going-private transactions. Such suits had become commonplace following the 1994 *Lynch* decision which unwittingly made it impossible for a claim to be dismissed on a motion by defendants when that claim alleges that the price to be paid in a going-private transaction is unfair. Defendants (the controller and usually the directors of the corporation) have a clear incentive to settle the matter without incurring the high cost of the discovery process. Importantly, plaintiffs' lawyers will be in line for a costs award for the supposed benefit of avoiding the costs of litigation. The costs award is based on the difference in price from the beginning of the litigation to the settlement, and even if the lawyers request a small fraction of the difference in costs, the costs award is significant-often in the millions of dollars. Therefore,

In the In re Cox Communications decision, Vice Chancellor Strine addresses a rare case of objection to an attorneys' fees award resulting from the filing of a suit to challenge the price proposal in a going-private transaction. To preserve the integrity of the judicial process while allowing for flexibility in corporate transactions, he applies the factors from the Sugarland case to determine the value of the award that should be given to the plaintiffs' counsel. He also suggests changes to the standard of review

that would make it more difficult to sustain non-meritorious challenges to share price proposals in going-private transactions involving special committee approval and "minority approval".

plaintiffs have an incentive to bring the action even if it has no merit. Defendants, somewhat hog-tied, are happy to pay the costs award rather than the cost of discovery. As a result, it has become common practice for suits to be filed as soon as there is a public announcement of a proposed going-private transaction.

Until *Cox* came along, the *Lynch* problem had been primarily a subject of academic debate. In this case, however, academics ventured into the judicial ring to oppose the settlement between plaintiffs and defendants-and specifically the lawyers' fees-in an attempt to halt a practice that they allege erodes the integrity of the judicial system. Although Vice Chancellor Strine found favour with the objectors' argument, he recognized some benefit in the litigation at hand and awarded plaintiffs' lawyers costs in an amount substantially reduced from what they requested and from what the defendants agreed to pay.

The facts of the case can be summarised as follows. Cox Communications, a major communications company, was controlled by the Cox family and had gone from private to public and back again several times over the years. The Cox family decided in the summer of 2004 to take the then-public company private again, and took steps to offer an initial bid in a merger transaction. The family was clear that it expected Cox Communications to form a special committee of independent directors to respond to the proposal and negotiate the terms of the merger. A public announcement was made that the family was offering $32 per share. The very morning of the public announcement of the proposal, several law firms raced to file claims that the proposed price was unfair, as they had done in many previous going-private transactions. This meant that two separate and parallel negotiations had to take place: the transactional negotiations between the Cox family and the special committee, and the settlement negotiations between the defendants (the Cox family and the company's directors) and the public shareholders.

Both negotiations were settled at the same price-$34.75 per share subject to a minority approval condition-as was standard practice post-*Lynch*. The closely choreographed *Lynch* dance continued as the plaintiffs' lawyers sought a costs award in recognition of the benefit of their efforts in achieving out-of-court settlement of the matter and, right on cue, the defendants waltzed in with an offer of $4.95 million-less than one percent of the value of the benefit of the litigation (or, more accurately, the value of the negotiations between the special committee and the Cox family).

The music stopped, however, when Prof. Elliott J. Weiss of the University of Arizona encouraged one individual shareholder and Franklin Mutual Advisers (manager of eleven funds) to object to the request for attorneys' fees. Vice Chancellor Strine noted Professor Weiss's view, expressed in an article in the *Vanderbilt Law Review*, that this type of lawsuit exists almost entirely to generate payment of attorneys' fees and to provide defendants with a judgment giving them a broad release from future lawsuits related to the transaction.

The key issue in this case, at least as conceived by Prof. Weiss, was how best to protect the integrity of the judicial process given the prevalence of non-meritorious claims in going-private transactions since *Lynch*.

The objectors advocated application of the test for justification of fee awards set out in *Chrysler v. Dann*:

> To justify an allowance of fees the action in which they are sought must have had merit at the time it was filed. It may not be a series of unjustified and unprovable charges of wrongdoing to the disadvantage of the corporation. The plaintiff must have some factual basis at least for the making of the charges. If there is none, then the conclusion follows that the action lacked merit and the plaintiff is entitled to no allowance for fees.
>
> …
>
> A claim is meritorious within the meaning of the rule if it can withstand a motion to dismiss on the pleadings if, at the same time, the plaintiff possesses knowledge of provable facts which hold out some reasonable likelihood of ultimate success. It is not necessary that factually there be absolute assurance of ultimate success, but only that there be some reasonable hope.

Vice Chancellor Strine, though clear that the plaintiffs' complaints in this and other similar claims were not meritorious when filed, resisted what he called the "undeniable appeal" of the objectors' argument. He noted the importance of flexibility in commercial law, and found that the *Dann* case was too rigid for this context.

Nonetheless, Vice Chancellor Strine found a more appropriate approach in *Sugarland Indus., Inc. v. Thomas*, a ruling that identifies five factors to consider in determining the size of a fee that should be awarded to plaintiffs: (i) the benefits

achieved in the action; (ii) the efforts of counsel and the time spent in connection with the case; (iii) the contingent nature of the case; (iv) the difficulty of the litigation; and (v) the standing and ability of counsel."

Using these factors as the basis for analysis, Vice Chancellor Strine found that although some fee award was deserved, the amount deserved was significantly less than the plaintiffs' lawyers requested (or, notably, than the defendants had been willing to pay). First, he noted that the bulk of the work in the negotiations had been carried out not by the plaintiffs' lawyers, but rather by the special committee. Nonetheless, Vice Chancellor Strine noted that litigation in going-private transactions appears to be correlated with better share value increases than in other cases, and that the litigation likely created some incentive for the defendants to settle their negotiations. In short, the action created some (if not great) benefit.

In applying the remaining factors, Vice Chancellor Strine was less sympathetic to the plaintiffs' lawyers. He noted that the efforts of counsel were minimal and the time spent was excessive and inefficiently managed. He noted the lack of risk borne by the plaintiffs and their counsel in bringing the case-and, indeed, the incentive that plaintiffs and counsel have in bringing such a case.

Vice Chancellor Strine thus gave some bite to the arguments of the objectors to bolster the integrity of the judicial process, while at the same time preserving the flexibility of the law in relation to corporate transactions.

He also went further, and suggested some reforms to the law in *Lynch*, which could prevent non-meritorious claims like this from arising. The problem with Lynch in going-private transactions is the inability of a Delaware court to dismiss non-meritorious claims because the standard of review – specifically, the "entire fairness" standard – creates a low threshold for maintenance of the claim (and therefore creates an immense nuisance factor). He suggests that the standard of review be changed to the business judgment rule when a going-private transaction with a controlling shareholder involves not just the approval of independent directors in a special committee of the board, but also the approval of the majority of the minority shareholders. This would reflect the process in an arm's-length transaction, and would create a burden on plaintiffs that would require that claims have some merit in order to be preserved.

In re J.P. Morgan Chase & Co. Shareholder Litigation

(2005) Cons. C.A. 531-N

Court of Chancery, State of Delaware

May 4, 2005

Here, plaintiffs' failure to bring the appropriate action and their further failure to make careful, particularized claims frustrated their efforts to receive compensation for an allegedly excessive 14% premium that J.P. Morgan Chase & Co. (JPMC) paid to shareholders of Bank One in a merger between the two banks. These failures also seemed to frustrate Vice Chancellor Lamb. Not only had the plaintiffs brought a direct action where a derivative action was clearly appropriate, but they had not attended to frequent admonitions of the Delaware court to seek a books and records inspection that would allow them to make well-pleaded allegations sufficient to support their claims.

Here's what had happened. In January 2004, JPMC and Bank One agreed to a merger that would create the second largest financial institution in the U.S. After negotiation, they agreed that JPMC would acquire Bank One by issuing common shares to Bank One's shareholders at a 14% premium over the closing price of the stock as of the date the merger was announced. They also agreed that the CEO of JPMC, William B. Harrison, would continue as CEO of the post-merger corporation for two years, after which time the CEO of Bank One, James Dimon, would succeed him. Over 99% of JPMC's shareholders voted in favour of the merger on these terms.

It was the negotiation of the CEO position that ultimately gave rise to the controversy in the case. During the course of negotiations, Dimon allegedly offered to sell Bank One to JPMC without a premium if he were appointed CEO of the post-merger company immediately. The *New York Times* reported this, and based on this article the plaintiffs charge that JPMC could have acquired Bank One for no premium. Thus, they claim that their stake in the post-merger company was diluted so that Harrison could be CEO. Of course, JPMC's board of directors had to approve the agreement before it went to a shareholder vote. The plaintiffs' argued that the board approval indicated either a lack of independence or lack of knowledge. The plaintiffs argued that the eleven outside directors on the board had business or other ties to Harrison that precluded them from voting against him, despite their fiduciary duties. In the alternative, they argued that Harrison secretly rejected Dimon's no-premium offer and brought only the 14%-premium offer to the board for approval.

In J.P. Morgan Chase & Co., Vice Chancellor Lamb granted the defendants' motion to dismiss shareholders claims of breaches of fiduciary duty and the duty of disclosure due to the shareholders' failure in the first place to bring a derivative action rather than a direct action, and in the second place to make sufficiently particularized claims. The plaintiffs claimed direct harm to themselves and to JPMC shareholders as a class where it was clear that the direct harm was to the corporation; any harm to the shareholders was indirect. Furthermore, the plaintiffs made conclusory allegations from which the court was not obliged to make inferences in the plaintiffs' favour. Although under Delaware law a court must accept as true all well-pleaded factual allegations in the complaint and all reasonable inferences to be drawn from those facts, the plaintiffs did not provide sufficient information to support their allegations. Plaintiffs' failure to seek a books and records inspection to uncover facts to support their claim was severely detrimental to their cause. In sum, poorly pleaded claims prevented the plaintiffs from maintaining their action.

The Issues

The issues before the court were (i) whether this was properly a direct or a derivative action, (ii) if the action was derivative, whether the demand required under Delaware law should be excused as futile for lack of independence of the board, and (iii) whether the board breached its fiduciary duty to disclose all material facts in the proxy statement.

The Court's View

(1) Applying the standard in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, it asked who suffered the harm (the corporation or the individual stockholders) and who would receive the benefit of any remedy (again, the corporation or the individual stockholders). Quoting from Tooley, the court noted, "[i]n order to show a direct injury…, a 'stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation.' " The plaintiffs attempted to show that their harm was direct by describing it as dilution of stockholdings; however, the court found that "[a]ny alleged dilution was a harm suffered by all pre-merger JPMC stockholders and, consequently, JPMC itself." The plaintiffs also attempted to show that the form of consideration-stock instead of cash-harmed them directly. Not only did the plaintiffs fail to cite persuasive authority for this proposition, but they also failed to note Delaware case law that states the contrary. The court cited *Avacus Partners, L.P. v. Brian*, which found that "if a board of directors authorizes the issuance of stock for no or grossly inadequate consideration, the corporation is directly injured and shareholders are injured derivatively." Furthermore, any remedy would benefit all stockholders, and thus JPMC itself. Consequently, the court dismissed the direct claim.

(2) *Jacobs v. Yang* (2004) interpreted Court of Chancery Rule 23.1 to require "a plaintiff shareholder [to] make a demand upon the corporation's current board to pursue derivative claims owned by the corporation before a shareholder is permitted to pursue legal action on the corporation's behalf." However, under *Aronson v. Lewis*, demand may be excused if "a shareholder [has pleaded] with particularity facts that establish that demand would be futile because the directors are not independent or disinterested," or if "a reasonable doubt is created that…the challenged transaction was otherwise the product of a valid exercise of business judgment."

The plaintiffs argued that at least eight of the eleven outside directors were not independent because of their relationships with Harrison. They listed the relationships: three directors were "intimately involved" with several of the largest corporations in the U.S., each of which conducts business with JPMC; another director's company had received over $2 billion from the Trade Bank of Iraq, which is managed by JPMC; fifth and sixth directors were trustees and executives of The American Museum of Natural History, which received large contributions from JPMC; a seventh director's son is employed by JPMC; and an eighth director was an executive of the United Negro College Fund, which also received a large contribution from JPMC.

Despite these assertions, the court did not find that the plaintiffs had established demand futility. Vice Chancellor Lamb did note the size of JPMC and the likelihood that it would have relationships with many major businesses and charities in the U.S. However, and importantly, he did not find that the directors were independent; rather, he found that the plaintiffs had failed to allege sufficiently particularized facts that would demonstrate a lack of independence on the part of the directors. He noted with some exasperation the "frequent admonitions of the Delaware Supreme Court and the Court of Chancery" that plaintiffs use a books and records inspection to arm themselves with sufficient information to plead sufficient facts to establish demand futility. The plaintiffs, though, made conclusory statements in their pleadings that did not support the inference that the directors were not independent.

The court was also unable to find that the plaintiffs had pleaded sufficient facts to show that their decision to approve the merger was the product of something other than the proper exercise of business judgment. Again, the plaintiffs failed to make claims that were sufficiently particularized. According to Vice Chancellor Lamb, "[t]he only allegation in the complaint is that somehow, due to their financial, charitable, or personal relationship to Harrison, the individual directors were beholden to Harrison, allegations that have already been found to be insufficient." As for the argument that Harrison had kept the no-premium offer a secret, the plaintiffs did not show that the directors were not sufficiently informed about the negotiations between Harrison and Dimon. In fact, the plaintiffs made contradictory statements in their pleadings, stating that Harrison did inform the board of (in order to be able to list the directors as defendants), but also stating that the directors were uninformed (in an attempt to preserve the demand futility argument). However, the plaintiffs did not show that any of the directors had acted without honesty or good faith, nor that the directors

were inadequately informed about the transaction. The Vice Chancellor therefore dismissed the derivative claim.

(3) The plaintiffs claimed that they and other JPMC shareholders had been harmed because the proxy statement did not include information about Dimon's no-premium offer. The court viewed this as an issue of whether the plaintiffs could be entitled to money damages individually, apart from the derivative claim. Disclosure claims yield equitable relief-injunctions, not money damages. The court noted that the plaintiffs had had time to seek a temporary restraining order to maintain status quo before the merger, but they failed to do this or to preserve any other claims for equitable remedies. This would have been an appropriate course of action. However, the plaintiffs sought compensatory damages from the directors. This, the court found, was not possible. Compensatory damages could only be awarded where the directors' have breached their disclosure duties in a corporate transaction caused impairment to shareholders' economic or voting rights. Once again, the plaintiffs failed to make a sufficiently well-pleaded claim to succeed.

Vice Chancellor Lamb made it clear in this case that plaintiffs-and plaintiffs' counsel-need to be careful to make particularized claims, delineate specific facts and reasoning to support the inferences they want the court to make, and perhaps most importantly to pay attention to the requests of the courts that will be hearing their cases.

In re General Motors (Hughes) Shareholder Litigation

(2005) Cons. C.A. No. 20269

Court of Chancery, State of Delaware

May 4, 2005

In the General Motors (Hughes) Shareholder Litigation, Vice Chancellor Chandler dismisses the claims against General Motors of breaches of the duty of loyalty, breaches of GM's Restated Certificate of Incorporation and dismisses claims against News Corporation Limited for aiding and abetting the individual defendants' breaches of fiduciary

The General Motors (Hughes) Shareholder Litigation is yet another case supporting the presumption that directors' decision-making will be protected by the business judgment rule unless there are particularized factual allegations of a breach of fiduciary duty. This case involved allegations concerning the conduct of the directors of General Motors (GM) when that company sold its wholly-owned subsidiary, Hughes Electronics Corporation (Hughes), to The News Corporation Limited (News). The plaintiffs (GMH shareholders) were holders of GM's Class H Common Stock, a "tracking stock" that represents the financial performance of the subsidiary. The case also involved allegations against News.

duty. Once again, poorly pleaded claims made up of conclusory allegations thwart shareholders' attempts to seek compensation.

The somewhat complicated facts of the case can be summarised as follows. GM decided that it wanted to sell Hughes to News. The transaction began by GM causing Hughes to amend its Certificate of Incorporation to increase the authorized common stock from one million to two billion shares. Hughes then paid a special cash dividend to its sole shareholder, GM, of $275 million. The amount of the dividend was established after obtaining four top financial advisors, and the dividend was approved by the majority of the GM $1 2/3 shareholders and the GMH shareholders, voting separately as classes, pursuant to a GM policy statement. GM announced the split-off in April 2003, a few days before an announcement that a Hughes subsidiary had exceeded expected earnings, and before Hughes announced its own 2003 figures. GM then redeemed the GMH shares for Hughes shares (which Hughes had previously issued to GM). This left GMH shareholders and GM itself with Hughes shares. GM sold its interest in Hughes to News, with consideration of $3.1 billion cash and stock (News ADSs) valued at approximately $1.0 billion. Finally, News acquired an additional interest in Hughes by merging one of its subsidiaries with Hughes. This left News with a 34% interest in Hughes (which it later transferred to another subsidiary, Fox Entertainment). It also left GMH shareholders with a combination of Hughes shares and News ADSs at the end of the transaction.

One further fact complicates matters. The GM board had an Investment Funds Committee (IFC), which was a named fiduciary under the Employee Retirement Income Security Act of 1974 for some of GM's pension plans. Of course, the members of the IFC were fiduciaries both of the GM board and of the pension plans. Problematically, GM's pension plans were significantly underfunded-by $19.3 billion by the end of 2002. GM attributed the GMH shares that it had redeemed to the pension fund, and later issued new GMH shares to the pension fund rather than selling them publicly.

As a result of these facts, the plaintiffs made seven claims.

Count I was for breach of the duty of loyalty and unjust enrichment in the payment of the special dividend. Count II was for breach of the duty of loyalty in failing to deal fairly with the GMH shareholders and compensate them fairly in the transactions. Count III was for breach of the duty of loyalty in manipulating the shareholder vote. Count IV was for breach of the duty of disclosure. Count V was for breach of GM's Restated Certificate of Incorporation, Article Seventh [i.e., was a supermajority required to approve the Hughes transaction?]. Count VI was for breach of GM's Restated Certificate of Incorporation, Article Fourth [i.e.,

was the requirement to treat all of GMs shareholders equally violated by the payment of the special dividend?]. Count VII was alleged against News for aiding and abetting a breach of fiduciary duty.

The plaintiffs succeeded in none of these claims. They failed to state a well-pleaded claim against GM's directors, or against News. Defendants brought, and succeeded in, motions to dismiss all claims.

The court interpreted the first and second claims as revolving around the independence of the directors. The plaintiffs claimed that the directors had conflicts that prevented them from meeting their duty of loyalty to the company, including GMH shareholders in particular. They argued that GM's directors received excessive compensation, and that they favoured other GM shareholders at the expense of GMH shareholders. However, these claims were not borne out in their pleadings. The court noted, "an allegation of a director's personal interest must show materiality as to that director." To overcome the business judgment rule, plaintiffs must show that any of the directors had a conflict of "material importance," one that "would have made it improbable that the director could perform her fiduciary duties without being influenced by her overriding personal interest." However, the plaintiffs did not include facts on how the salary and benefits of the directors (with the exception of one) impacted their individual economic well-being. Nor did they plead any facts to support their allegation that any single director would receive a benefit from the Hughes transaction at the expense of the shareholders or that any director or directors would have been able to dominate the others to produce a self-interested result. In short, the plaintiffs failed to meet their burden.

The third count, relating to the shareholder ratification of the special dividend, also attracted the protection of the business judgment rule. Plaintiffs argued that the shareholder vote was "rigged" by the contribution of GMH stock to the pension plans and the timing of the split-off announcement. The court noted that, under *Blasius Indus., Inc. v. Atlas Corp.*, the plaintiffs must make a threshold showing of facts "that would allow the court to infer that the primary purpose of the fiduciary's conduct was to thwart the exercise of a shareholder vote"; otherwise, the business judgment rule presumes the conduct of the board to be in accordance with its duties. Again, the plaintiffs failed to meet their burden. They failed to allege that GM exerted, or even had, the power to direct how GMH holders would vote; they failed to allege that the approval of the Hughes transaction was a condition precedent to the pension plans receiving the GMH

funds; they failed to allege that the percentage of shares that the pension plans held was material in affecting the outcome of the vote; they failed to allege any facts to say that their will was thwarted. Some such allegations were necessary to create a well-pleaded claim. The plaintiffs similarly failed to support their allegations relating to the timing of the announcement of the split-off.

The allegation of the breach of disclosure duty included seven challenges to the Consent Solicitation that was sent to shareholders for a vote. These challenges included allegations that the disclosure concerning the special dividend was incomplete; that the information regarding the financial advisors' analyses was inaccurate; and that the legal effect of the ratification was misstated, among other challenges. The court dismissed all of the challenges by what can be described overall as a finding that the disclosure was sufficient to allow a reasonable shareholder to understand the nature of the transaction and the processes behind the decisions of the board that related to the transaction. The plaintiffs did not plead particularized facts to show any material deficiency in the disclosure.

The court dismissed the claims regarding alleged breaches of the Restated Certificate of Incorporation in short order. The Restated Certificate of Incorporation - a contract between the corporation and its shareholders-was permissive, authorizing the directors to take certain actions with the approval of the shareholders. However, it also clearly provided that it was not in limitation of Delaware law, which permits a transaction such as the Hughes transaction without a shareholder vote, let alone a supermajority vote. The payment of the special dividend was put to a shareholder vote and was ratified; therefore, even if it was in breach of the Restated Certificate of Incorporation, that breach would be cured by the shareholder ratification.

Finally, the court turned to the allegation that News aided and abetted in a breach of fiduciary duty. Since the court found no breach of fiduciary duty, this claim was bound to fail. However, the court did go on to note certain deficiencies in the plaintiffs' pleadings. The plaintiffs failed to plead facts that would allow the court to infer that News knowingly participated in a breach, and rather pleaded conclusory allegations.

The plaintiffs' failure to bring a single well-pleaded claim, largely due to their failure to overcome the presumption of the business judgment rule, caused the court to grant the defendants' motions to dismiss.

In re Telecommunications, Inc. Shareholders Litigation

Unreported, Delaware Court of Chancery

December 21, 2005

Delaware court questions independence of special committee that had recommended approval of a merger agreement and transaction that provided a large premium to a class of shares owned mainly by directors. Special committees should consider issues of fairness as between classes, rather than simply assessing the benefit each class is to receive in isolation.

TCI, a public company, had a number of separate series of stock that tracked the price of individual TCI divisions. TCI Group, the division that was to be merged into AT&T was tracked by two such series, "A" and "B" that were identical except that B shares carried 10 votes and A shares just 1. Because the B shares belonged mainly to directors of the company and the president, Malone, was insisting that he wouldn't support the merger unless the B's received a 10% premium, there was an obvious potential conflict of interest. In response, a Special Committee was created.

The Special Committee was made up of two directors. One held mostly A shares while the other was heavily invested in B's. Donaldson, Lufkin & Jenrette (DLJ), which was regularly retained by TCI on other matters, provided an analysis and fairness opinion noting that in some comparable transactions "high-voting" shares had been valued at a premium, although these were "less common" than transactions in which no such premium had been granted.

The Special Committee and the full Board of Directors approved the transaction. Holders of A shares were to receive AT&T stock valued at 37% more than their TCI shares, while the premium for B shares was to be 52%. By the time of the transaction an increase in the value of AT&T shares more than doubled these premiums.

The net gain to the board members as a result of the unequal valuations was $220 million, including $130 million for Malone. The Special Committee member who had mainly B shares gained $1 million. After the recommendation was made, he and the second member were each compensated $1 million for their Special Committee service (not bad for attending four meetings, as Chancellor Chandler dryly noted). 99.89% of the company's shares were voted in favour of the merger, which closed in March 1999.

This Proceeding

All was not happily ever after. A group of disgruntled A shareholders began class action proceedings against the company and its directors. The current hearing represented TCI's initial response-an attempt to put a stop to proceedings by means of a summary judgment. For the most part, this failed. In the view of Chancellor Chandler, the complaint filed by the A shareholders raised numerous triable issues, although a few individual allegations could be, and were, dismissed. In spite of the fact that this was only a summary judgment motion, Chancellor

Chandler had some important things to say about the conduct of merger negotiations and the role and duties of a special committee.

Disclosure Claims

As a preliminary matter, TCI asked the court to dismiss several of the shareholders' claims relating to allegedly deficient disclosure in its Proxy Statement. A complaint that TCI hadn't included the total values of options held by its directors and officers was struck out on the ground that the number and individual value of the shares were provided. Chancellor Chandler was of the view that shareholders could do the math, so to speak. He also held that, contrary to a second argument advanced by counsel, there was no need for the Proxy Statement to provide a blow-by-blow account of the Special Committee's deliberations about the premium.

Entire Fairness-Fair Dealing

Delaware law puts the onus on directors holding a significant non-majority interest in voting shares to make out a *prima facie* case that a transaction passes an "Entire Fairness" test-at least where their personal interests diverge significantly from those of other shareholders. The Entire Fairness test has a procedural ("fair dealing") component and also a substantive one ("fair price"). Chancellor Chandler began with the former, which requires the defendant to show that no procedural deficiencies existed in five areas:

The Clarity of the Special Committee's Mandate

The minutes of the board revealed no discussion at all of the precise mandate of the Committee. The first member deposed that he understood his role as that of representing the interests of the A shareholders, while the second deposed he was of the view that the Committee's job was to safeguard the interests of both A and B shareholders. To Chancellor Chandler, these differences suggested that the Committee's purpose had not been thought through very thoroughly. Thus the issue could not be resolved in the absence of a trial.

The Choice of Directors for the Special Committee

Chancellor Chandler agreed that the choice of a Special Committee member who was heavily invested in B shares was odd, given that there were several directors who, like the vast majority of non-director shareholders, held mostly A shares.

The Choice of Advisors to the Special Committee

TCI had made two very significant errors in selecting a financial advisor to the Committee. First, they chose an advisor (DLJ) that was the company's own principal advisor. And second, they did not pay DLJ up front. Each of these decisions raised legitimate questions about independence. Chancellor Chandler rejected the argument that the company was justified in hiring DLJ and making its compensation contingent because it had a legitimate interest in trying to avoid paying a lot up front and then having the deal fall through. This sends a clear signal that special committees should engage independent financial advisors on a non-contingent basis.

Diligence of Research and the Fairness Opinion

On the evidence before Chancellor Chandler, it appeared that the Special Committee had had little basis for its decision to approve a premium for the B shareholders. The Special Committee members seem to have relied mainly on their personal intuitions and on a presentation by DLJ. But DLJ's analysis was inadequate, in Chancellor Chandler's view. For example, it looked to Malone's call option agreement with TCI, which promised to pay him market value plus up to 10% as a premium. Given that the agreement was not at arm's length it was an odd indicator of the actual relative value of the B series. A further difficulty was that the DLJ report had made much of four comparable acquisitions in which premiums had been paid for high-vote stock, while paying less attention to a larger number of cases in which no premium had been paid.

Arm's Length Bargaining

The member of the Special Committee with the large B holding, convinced that Malone would not allow the deal without the premium, did not press the issue as a genuinely arm's-length Special Committee member might have, Chancellor Chandler determined.

Entire Fairness-Fair Price

TCI fared no better when it came to the second component of the Entire Fairness test. The company's main defence was the fact that the A shareholders had received a very substantial premium to market. However, Delaware's 2002 Levco decision requires not only that the price be fair to each class considered independently (as this price was), but that it be fair to each class in relation to all other classes. Following *Levco*, Chancellor Chandler held that it was the duty of the Special Committee to turn its mind to the "specific impact of the preferential payment upon the disadvantaged class".

The Result

As this was simply a motion for summary judgment, Chancellor Chandler did not resolve any of the substantive issues in the case. But he did decide that the dissatisfied A shareholders had raised genuinely substantive issues and strongly suggested that they might not have been issues if the company had struck a more independent Special Committee and given it a clear mandate to look after the interests of all of the shareholders.

In Re Toys "R" Us, Inc., Shareholders Litigation
(2005) No. 1212-N
Court of Chancery, State of Delaware
June 22, 2005

The Delaware Court of Chancery has denied a motion for an injunction preventing Toys "R" Us stockholders from voting on a joint $6.6 billion ($26.75 per share) buyout offer by Kohlberg Kravis Roberts & Co., Bain Capital Partners and Vornado Realty Trust, three leading private equity investors. The motion was brought on behalf of shareholders who claimed that the Toys "R" Us board of directors had breached its so-called Revlon duties by failing to seek bids from a sufficiently broad range of potential investors and by granting allegedly excessive deal protection, including a 3.75% break fee, to KKR.

The Delaware Court of Chancery has declined to second-guess a sale process conducted by a diligent and well-informed board that included a high break fee deemed reasonable under the circumstances.

The ruling by Vice Chancellor Strine denied a motion by unhappy shareholders of Toys "R" Us, Inc. (Toys or the Company) for a preliminary injunction that would have halted a $6.6 billion deal to sell the Company to a private equity investor "club" that included Kohlberg Kravis Roberts & Co., Bain Capital Partners and Vornado Realty Trust (collectively, KBV).

The process that the Toys board had followed in seeking potential purchasers was one of the main points of contention. The Company's investment bankers, CSFB, had initially contacted 29 potential buyers. Upon reviewing the resulting

preliminary bids, the Board concluded that shareholder value would be maximized if the Company sold its toy store division (Global Toys) but kept the much smaller "Babies "R" Us". After considerable due diligence, the field of bidders was narrowed to four: KKR alone, Bain and Vornado together, and groups led by Apollo and Cerberus. Although the bids were supposed to be for Global Toys alone, Cerberus jumped in, late in the game, with a bid for the whole company. The Toys board suddenly found itself in a difficult position: how to pursue the possibility of selling the whole company without risking the loss of some promising bids for Global Toys alone.

Determining that time was of the essence, the board decided to ask the existing bidders to bid on the whole company, with a tight eight-day deadline. This decision was influenced by earlier due diligence that had suggested that the universe of potential buyers for the whole company was small-an understanding that seemed to have been confirmed (in Vice Chancellor Strine's view) by the absence of any new inquiries when The *Wall Street Journal* reported that the whole of Toys "R" Us was in play. In the end, KKR teamed up with Bain and Vornado to make a $6.6 billion bid for the whole company. At $26.75 per share, this was a full $1.50 above Cerberus' final bid and at or beyond the top end of the valuation ranges that the board had received for the Company. The board decided to accept the bid, including a 3.75% break fee that was somewhat higher than the current standard, a "no shop" provision, a provision that the board could entertain a superior proposal provided that it was for at least 50% of the Company, and a right to match any competing offer.

The case raised important questions relating, among other things, to the board's possible breach of its *Revlon* duty to maximize shareholder return and with respect to the "deal protection" provisions. In a forthright and entertaining opinion, Vice Chancellor Strine made a number of important points, while dismissing every argument the plaintiff shareholders raised:

(1) The Delaware courts will not invoke *Revlon* to undermine a reasonable sale process executed in good faith by a well-informed board. Throughout his ruling, Vice Chancellor Strine emphasized the "real world" realities of the board's situation and the lengths to which it had gone to decide what was best for the shareholders. He rejected the plaintiffs' main complaint-that offers for the whole Company had been solicited from four potential bidders only-in light of the circumstances in which the directors had found themselves. They had acted reasonably to protect the existing bids while seeking new ones.

(2) There is no "bright line" test for break fees. A high fee was acceptable in this case because the board had concluded, after much due diligence, that the KBV offer was a good one, hundreds of millions better than Cerberus', and thus unlikely to be significantly bettered. Vice Chancellor Strine noted that the 3.75% fee would economically inhibit only those potential bidders who might have planned to top the KBV offer by 20 cents or less. To jeopardize a bid that had topped all others by $1.50 in order to preserve the faint hope that another 10 or 20 cents might materialize from some unknown quarter would not have been reasonable. Vice Chancellor Strine observed that the purpose of *Revlon* is to "ensure the fidelity of fiduciaries", not to attempt to push bids right up to, or beyond, the upper bound of economic rationality, adding: "For society as a whole, there are real economic and social costs to the acquisition of healthy, profitable companies at an excessive price. Creditors, consumers, workers, and communities can suffer when that happens."

(3) The plaintiffs argued that the "no shop" provision-which allowed consideration of superior offers only where they were for 50% or more of the Company-constituted a violation of the board's duties in virtue of the fact that it precluded bids for Babies "R" Us alone. Vice Chancellor Strine declared that this argument failed the "straight face test", since there was no evidence that a standalone Babies "R" Us was of any interest to anyone.

(4) Some U.S. commentators have noted that Vice Chancellor Strine appears to endorse the use of enterprise value (basically being the market capitalization plus long-term debt less cash and investments) as an alternative basis for the calculation of break fees in certain circumstances (although not in this particular case). As this would be a marked departure from the current understanding of Delaware law, making it simpler to negotiate deal protection for highly leveraged targets, it will be interesting to see whether subsequent practice, or subsequent decisions, pick up on the remarks made here by Vice Chancellor Strine.

(5) There was nothing wrong with the board's decision to permit KKR and the Bain-Vornado team from forming a private equity club part way through the process. Vice Chancellor Strine dismissed the plaintiffs' claim that this amounted to "collusion", calling this "a naked attempt to use inflammatory words to mask a weak argument" and noting that it made more sense to suppose that there would have been no bid at all in the absence of the club.

A final point to note is the tone of the reasons, which is notably unsympathetic to recent calls to step up the judicial scrutiny of board decision making. That trend is exemplified by the 2002 *Omnicare* decision, which purported to clamp down on deal protection mechanisms. According to Vice Chancellor Strine, *Omnicare* was "an aberrational departure from [the] long accepted principle" that the court must look at board decisions primarily from the point of view of the directors at the time. Vice Chancellor Strine also repeatedly made rather sarcastic remarks about the plaintiffs, whom he clearly regarded as opportunists, noting (for instance) that they had "hedged their bets" by selling a large number of shares for less than the price offered by KBV and that they had somewhat hypocritically demanded that KBV be required to maintain its offer during the period in which, if this motion had succeeded, the board would have had to look around for more bids.

Frontier Oil Corporation v. Holly Corporation

(2005) C. A. No. 20502

Court of Chancery, State of Delaware

April 29, 2005

In this action, the Delaware Court of Chancery determined that, in the context of a merger agreement, a pending mass tort litigation against one party cannot automatically be classified as a material adverse effect. The existence of mass tort litigation is not necessarily fatal to the targeted entity; rather, the materiality of the effect can only be determined by a reasoned and logical analysis of the potential outcome of the litigation and a reasonable estimate of defence costs. In this action, the plaintiffs did not successfully prove that the mass tort litigation would be successful or that the defence costs would be devastating from a long-term perspective.

Frontier Oil Corporation and Holly Corporation, two mid-sized petroleum refiners, had enthusiastically negotiated a merger agreement under which Holly shareholders would receive cash and Frontier stock. Prior to signing the agreement, Holly became aware that well-known activist Erin Brockovich was preparing to initiate a mass toxic tort case, claiming that an oilrig in operation for decades on the campus of Beverly Hills High School in California had released air contaminants that had caused a disproportionately high incidence of cancer amongst students. Oil production activities at the site were being carried out by Venoco, Inc., a company that had acquired its interest from Wainoco Oil & Gas Company, a wholly owned subsidiary of Frontier.

Frontier insisted that this would not impact it, since it was protected from liability by "corporate separateness" that confined any liability to its subsidiary, Wainoco. In order to assuage Holly's continued concern, however, Frontier agreed to modify the merger agreement by: (i) giving a representation and warranty that there were no threatened actions against Frontier or its subsidiaries "other than those that would not have or reasonably be expected to have…a Material Adverse Effect"; (ii) modifying the definition of "Material Adverse Effect" to mean "a material adverse effect with respect to: (A) the business, assets and liabilities (taken together), results of operations, condition

(financial or otherwise) or prospects of a party and its subsidiaries on a consolidated basis.."; and (iii) adding a schedule to Frontier's disclosure letter expressing that Holly's knowledge about the threatened litigation against Wainoco would have no effect or limitation of any rights of Holly under the agreement.

Before the merger was completed, the parties learned that Frontier would not be able to rely on a "corporate separateness" defense after all because it had guaranteed Wainoco's obligations under the lease for the oil production site. Further, a new analysis of Holly's plans relating to a master limited partnership indicated that Holly's pipeline assets had been undervalued and that the merger deal with Frontier was significantly more beneficial for Frontier than originally expected. These developments, and the fact that the threatened litigation actually materialized, dampened Holly's appetite to complete the merger as agreed.
Attempts were made to renegotiate the merger agreement, to no avail. Finally, Frontier seized the nettle, claiming anticipatory breach and that Holly had repudiated the agreement causing Frontier to suffer substantial damages to the tune of $160 million. Holly counterclaimed that Frontier had breached its representation that the mass tort litigation "would not have or reasonably be expected to have" a MAE, and that Frontier had wrongly repudiated the merger agreement.

Repudiation

In concluding that Frontier had not proven Holly had repudiated the merger agreement, Chancellor Noble noted that it is not a repudiation if one party simply states that it will not proceed to closing by the letter of the agreement. It is only repudiation if the party states unequivocally that it will not close and that it also will not comply with the process of termination provided in the agreement. The fact that the parties had been engaged in renegotiating the deal spoke against a repudiation.

In response to Holly's counterclaim that Frontier had wrongfully repudiated the merger agreement, the court agreed that Frontier's actions of mistakenly concluding Holly had repudiated and subsequently ceasing its efforts to complete the transactions did amount to a wrongful repudiation. Holly was only awarded nominal damages, however, because the court found that Holly had already decided prior to the repudiation that the merger would not happen on the original terms so there was no possibility that Holly would have benefited from the agreement as contemplated.

Material Adverse Effect

In concluding that the circumstances in this case did not give rise to an MAE, the court stressed that determination of an MAE was fact specific, commenting that the "notion of an MAE is imprecise and varies both with the context of the transaction and its parties and the words chosen by the parties."

Relying on the rule enunciated in *Re IBP, Inc. Shareholders Litigation* (2001), Chancellor Noble found that the burden of proof lies on the party asserting the MAE (in this case, Holly), and that the Material Adverse Effect must "threaten the overall earnings potential of the target in a durationally significant manner".

Although the court recognized that there would be substantial expense associated with defending the class action proceedings, the court found that they did not satisfy the MAE thresholds required by IBP. These costs (estimated at between $15 and $20 million) were deemed unlikely to plunge Frontier, a company with an enterprise value of $338 million, into long term difficulties. While also recognizing the possibility of a potentially "catastrophic" damages award (which arguably could meet the "durationally significant" test promulgated by the court in re IBP), Vice Chancellor Noble found that Holly had not met its burden because it had failed to demonstrate that Frontier would be unable to absorb this amount without experiencing a material adverse effect over the longer term (even though Holly would have been put in the awkward position of having to argue the plaintiffs' claims in the tort litigation to be in a position to quantify the damage).

Practical Lessons

The underlying message for practitioners is that both repudiation and reliance on an MAE are uncertain means of withdrawing from a deal. In particular, MAE clauses should be drafted with caution, particularly if they are intended to address specific, identified risks (as opposed to
an unknown risk). The following methods have been distilled from the decision to assist merger parties to preserve the protections they seek:

(1) Word the MAE carefully, in particular keeping in mind the different thresholds which attach to the phrases "would reasonably be expected to have" and "could reasonably be expected to have". In this case, the court said that "could" presents a lower burden than "would". Ensure appropriate thresholds and risk allocation are selected.

(2) Specifically address areas of concern in the drafting of the MAE (in this case, Holly failed to refer specifically to the environmental class action). Specify events which allow the agreement to be terminated (for example, incorporating them as specific and objective closing conditions), rather than relying on a generally worded boilerplate MAE.

(3) Add precision to the meaning of MAE, e.g. by including a monetary threshold or quantifying future effects by determining the present value of future effects. In this case, the threatened litigation could have been addressed by specifically providing for an out in the event that litigation was commenced, or providing for a mandatory price adjustment in the event specified events occurred (because no such triggers were provided in this case, Holly needed to prove the likelihood that the litigation would be decided adversely, thereby being in the awkward position of having to substantiate the plaintiffs claims).

(4) The course of negotiations in this case was complicated by the existence of a very expansive "fiduciary out", allowing Holly extraordinary latitude at a relatively small cost (broadly, if Holly's board decided not to endorse the merger agreement for any reason, Holly was entitled to exit, subject to a break fee of $16 million). This relatively straightforward (and inexpensive) exit mechanism was at the back of Frontier's mind when it played the repudiation card claiming damages in the amount of $160 million. From a tactical perspective, it would have been preferable for Frontier to draft the "fiduciary out" such that it was restricted to tightly circumscribed scenarios (for example, by restricting it to a "superior proposal" scenario).

In this action, the Delaware Court of Chancery was given the task of valuing the worth of an Access Agreement between Liberty Digital and AT&T. The Agreement was an agreement to agree, under which Liberty Digital would negotiate the receipt of preferential access to interactive digital cable channels, contingent on the deployment of the necessary top-set boxes by AT&T. Given that the parties had never arrived at definitive terms for the agreement nor was there any expectation that the top-set boxes would be deployed in the near future, the court delivered a stinging opinion that the plaintiffs had vastly over-valued the Access Agreement. In the result, Vice Chancellor Strine determined that Liberty Digital was actually worth $133 million less than the consideration paid at the time of the merger.

Harold Finkelstein and Marilyn Finkelstein v. Liberty Digital, Inc.

(2005) C.A. NO. 19598

Court of Chancery, State of Delaware

April 25, 2005

In this action, Vice Chancellor Strine delivered a scathing ruling regarding the valuation of the Liberty Digital shares of common stock. Rather than valuing the entire company, the court had a limited valuation task of discerning whether the fair value of shares of Liberty Digital common stock should be increased in light of any value arising out of an "Access Agreement" between Liberty Digital and AT& T.

Vice Chancellor Strine ultimately concluded that the Access Agreement, while valuable, was essentially an agreement to agree with only the weakest sort of contractual force. The Agreement provided that Liberty Digital would have preferential access to channel space on AT&T's digital cable network when and if the technology was created and deployed. The court embarked on a detailed valuation analysis before concluding that, contrary to the petitioners' valuation of $2.2 billion, the Agreement was actually worth only $135 million.

In March 2002, Liberty Digital was merged with an acquisition subsidiary of Liberty Media Corporation and survived as a wholly owned subsidiary of Liberty Media. Liberty Digital's public stockholders received ¼ of a share of Liberty Media Class A stock for each Liberty Digital share, implying a value of $3.31 per share of Liberty Digital stock. The petitioners and Liberty Digital stipulated that the fair value of Liberty Digital's assets other than the Access Agreement was $497,627,000 (or $2.15) per Liberty Digital share.

The Access Agreement established a framework for negotiating a definitive agreement for Liberty Digital to access 12-18 interactive digital video programming channels. However, until AT&T created the "advanced set-top boxes" and came to an agreement with Liberty Digital, no potential programming partners would contract with Liberty Digital in their efforts to secure programming in advance of the technology. Despite Liberty Digital's best efforts throughout 1999-2001 to arrive at a definitive agreement with AT&T, it became increasingly evident that the interactive digital services were not forthcoming and that AT&T was reluctant to come to an agreement.

Vice Chancellor Strine speculated that the suit was partly motivated by the research reports published before the March 2002 merger in which equity analysts had published wildly unfounded analyses of Liberty Digital's supposed worth on a "discounted cash flow" (DCF) basis.

The court was faced with the task of determining the fair value of the petitioners' shares on the date of the merger, exclusive of any value arising from the merger itself. Under Delaware law, fair value is largely a legal concept influenced by policy considerations. Accordingly, the court was not concerned with the real-world economic value of the petitioners' shares, but rather the value of the shares on the assumption they were entitled to a pro rata interest in the value of the firm when considered as a going concern.

In Vice Chancellor Strine's view, the petitioners' $2.2 billion valuation was "entirely untethered to reality." Its expert report failed to consider the actual circumstances facing Liberty Digital as of the merger date. Feinstein's DCF valuation started from the assumption that Liberty Digital would ultimately provide twelve interactive channels on AT&T's networks. Feinstein assumed Liberty Digital would manage to launch two channels each year from 2004-2006. He assumed each channel would earn revenues equal to $0.75 per digital subscriber (he based this revenue estimate on the revenues received by the Home Shopping Network and QVC).

The court found numerous weaknesses and outright errors in the valuation: the lack of evidence that AT&T would be rolling out advanced set-top boxes in the foreseeable future; the fact that programming and product partners were required for the interactive channels and those partners had expected a material ownership interest in the channels; the fact that it erroneously inflated the per subscriber revenue received by HSN and QVC ($0.57 instead of $0.75)-not to mention that the lack of any basis to suppose that Liberty Digital channels would immediately enjoy a revenue stream to match those of two successful established channels.

The DCF analysis was a "fantasy", Vice Chancellor Strine concluded.

The respondent's valuation came in at a more modest $83.4 million. Vice Chancellor Strine agreed that the Access Agreement was a "unique contract right of uncertain value, with language that the parties disputed and that therefore was of dubious specific enforceability, but that potentially offered a material advantage

to Liberty Digital if it could be parlayed into an actual, finalized affiliated agreement with definite terms."

The $83.4 million figure was based not on an unsubstantiated DCF but on the assumption that the Access Agreement would ultimately have secured Liberty Digital some preferential treatment from AT&T. Katz, the valuator, assumed that Liberty Digital would not have been required to pay the launch support or carriage fees usually associated with starting new channels on a digital cable system.

The court asserted that the real question to ask in order to value the Agreement was how much a third party would actually have paid for it. Given the lack of real world data on which to base a valuation, the court agreed with Katz that relying on launch and carriage fees was a reasonable alternative to a traditional DCF analysis.

Katz concluded that the mean cost of carriage per subscriber of the relevant type of channel was $2.58. However, in light of the indefiniteness of the agreement, Katz had arbitrarily lowered his metric for valuation to $2.00, an adjustment that the court did not agree with. Thus, the court multiplied $2.58 by the number of AT&T digital subscribers at the time of merger (3.475 million) and multiplied that number by 15 channels for a result of $134.55 million. The court therefore concluded that in addition to the value of Liberty Digital's other assets ($497 million), the total value was around $632 million.

The court concluded that the value of Liberty Digital shares at the time of merger was $2.74 per share and awarded the petitioners that amount, together with pre-judgment interest at 5.56%, compounded monthly from the time of the merger through the date of the opinion. The petitioners' shares were therefore valued at less than the $3.31 per share they had originally been paid at the time of the merger transaction.

The Finkelstein case reflects the court's movement away from relying on DCF valuations, and turning instead to an analysis of arms-length bargaining in order to determine fair value. By relying on an inflated DCF valuation, the petitioners challenged the valuation of their shares and ultimately received a verdict that Liberty Digital was worth $133 million less than the consideration paid at the time of the merger.

Nick Gilliland v. Motorola, Inc. and Next Level Communications, Inc.

(2005) C.A. No. 411-N

Court of Chancery, State of Delaware

March 4, 2005

This opinion and order of Vice Chancellor Lamb follows an earlier opinion in which the Court of Chancery found a majority stockholder had breached its fiduciary duty to properly disclose information in a notice of short-form merger. In this case, the plaintiff, a former stockholder, requested relief in the form of a class-based "quasi-appraisal" on behalf of all the stockholders whose shares were exchanged for cash in the squeeze-out merger.

Here, plaintiffs were found to be entitled to a quasi-appraisal where there had been a technical deficiency in the disclosure provided by the defendants in the context of a short-form merger. The quasi-appraisal was awarded because, had the disclosure been completed properly, a statutory appraisal would have been available to the minority shareholders. Where a statutory appraisal is no longer applicable but the court determines that the plaintiff is entitled to a remedy, the court has the discretion to define a quasi-appraisal approach. Vice Chancellor Lamb deduced that the opt-in and risk features of the appraisal statute as well as the approach of valuing the shares at their fair value at the time of the merger should be used as guidance for how to conduct the quasi-appraisal.

In this action, Vice Chancellor Lamb ultimately concluded that the relief should be granted, but under a more limited form of "quasi-appraisal," based on the analogous Nebel case and based on the specific context of the claim for relief.

The Fiduciary Duty

In 2003, Motorola had launched a tender offer of $1.04 per share (eventually increased to $1.18) for the 26% of Next Level Communications, Inc. that it did not already own. Next Level's minority shareholders were cashed-out at $1.18 per share as part of the subsequent short-form Delaware merger.

The plaintiff responded by suing Motorola and Next Level for breach of fiduciary duty, arguing that the notice provided for the short-from merger didn't meet the requirements of Delaware law regarding appraisals.

The Court of Chancery agreed, ruling in 2004 that the defendants had indeed breached their fiduciary duty by not providing any disclosure relating to Next Level's financial condition. Although Next Level had disseminated financial information in connection with the first-step tender offer, the law still required summary information for the subsequent transaction.

Consequences Of The Breach

What to do about it then? In this 2005 hearing designed to answer that question, the plaintiff claimed that in light of the breach of fiduciary duty, all of those minority stockholders eliminated in the short-from merger should receive the

difference between the merger price ($1.18 per share) and a court-determined fair value of the shares. The defendants preferred a modified quasi-appraisal more like the appraisal remedy available by statutory right.

Delaware's short-form merger statute prescribes that a majority stockholder with at least 90% of a company's shares is able to eliminate minority stockholders summarily and without notice. The only remedy available to a minority stockholder is appraisal. Statutory appraisal was no longer available to Gilliland for two reasons: (i) because the minority stockholders no longer owned the shares in Next Level (a requirement of the statute); and (ii) because the two-year delay made it impossible to recreate the necessary factual context.

Quasi-Appraisal

For situations where a person may have been wrongfully deprived of the statutory remedy of appraisal, Delaware courts will apply the doctrine of "quasi-appraisal". Quasi-appraisal was initially introduced as a remedy for minority shareholders who had tendered their shares on an uninformed basis and were therefore precluded from seeking appraisal. The *Nebel* case expanded the doctrine to apply to minority stockholders who were prevented from demanding statutory appraisal because of a failure to comply with the notice provisions of the statute itself.

In *Nebel*, the defendants had breached the notice requirements by omitting a page of Delaware's appraisal statute. The *Nebel* court determined the plaintiffs were entitled to a quasi-appraisal remedy by means of which they would be awarded their proportionate share of the statutory fair value of the target.

Since this case also dealt with technically deficient merger notices, Vice Chancellor Lamb concluded that the minority shareholders were entitled to some form of quasi-appraisal. But how to do this? Vice Chancellor Lamb identified three relevant features of the appraisal statute: (i) it's an opt-in statute (only those minority stockholders who demand appraisal are entitled to receive the statutory fair value); (ii) it contains certain risks for the stockholders (notably the risk that the appraisal could result in a lower amount than the merger price); and (iii) it entitles the minority stockholders to the fair value of the shares as of the merger date.

(1) In light of the opt-in approach of the statute, the court ruled that the appropriate remedy in the circumstances was to require minority stockholders to make a choice to participate in the action, "in order to replicate the situation they would have faced if they had received proper notice." However, as opposed to the strict opt-in features in the statute, the shareholders would only be required to provide proof of beneficial ownership of the shares on the merger date.

(2) Similarly, the court found it necessary to structure the quasi-appraisal with "a modicum of the risk that would inhere if this were an actual appraisal action." Accordingly, the shareholders who chose to participate in the action would need to pay into escrow a portion of the merger consideration they had received. Given that Motorola's initial offer was $1.04 and subsequent offer was $1.18, the court concluded that the escrowed amount should be $0.14-an amount "both large enough to generate careful decision making and small enough not to deter participation by those who would have demanded appraisal in 2003 if the notice of merger had contained adequate information." If the appraisal came in at less than $1.18, the class would be limited to a loss of $0.14 per share.

(3) The court also decided to follow the statute's approach of valuing the shares at their fair value as of the merger date. According to prior case law, had one of the parties produced a reasonable estimate of value, the court may have followed their suggestion. However, since neither party offered an alternative valuation process to the statute the court was free to use its discretion, which in this case was to follow the statute's prescribed approach.

The Court's Ruling

Vice Chancellor Lamb concluded the opinion by granting the plaintiff and other minority stockholders who opt-in and return $0.14 per share the opportunity to seek quasi-appraisal. The fair value valuation would ensue once a class had been established. The court outlined a timeline for the parties to proceed, under which notice would be sent to the stockholders no later than April 15, 2005. The parties were to come to an agreement regarding notice and other required procedures and to report their results by March 23, 2005.

Given that the plaintiff had been successful in winning the minority stockholders the opportunity to seek quasi-appraisal, the court concluded that the plaintiffs were entitled to have their counsel fees paid for.

III. CERTAIN REGULATORY DEVELOPMENTS IN CANADA

Ontario Securities Commission Rule 62-503 - *Financing of Take-over Bids and Issuer Bids*

Ontario Securities Commission Rule 62-503 – *Financing of Take-over Bids* and Issuer Bids (Rule 62-503) was approved on December 7, 2005 and came into force on December 22, 2005. Rule 62-503 is intended to clarify the bid financing requirement that is set out in Section 96 of the *Securities Act* (Ontario). Some uncertainty has arisen regarding the law relating to bid financing conditions as a result of the judgment of the Ontario Superior Court of Justice in *BNY Capital Corp. v. Katotakis* (summarized earlier in this edition of The Valuation Law Review). Rule 62-503 addresses this uncertainty by confirming the extent to which conditionality in a bid financing arrangement is acceptable. Under Rule 62-503, financing arrangements may be subject to conditions if, at the time the bid is commenced, the offeror reasonably believes the possibility to be remote that the offeror will be unable to pay for securities deposited under the bid solely due to a financing condition not being satisfied.

Civil Liability For Secondary Market Disclosure

Legislative provisions and regulatory amendments to the *Ontario Securities Act* relating to civil liability for secondary market disclosure took effect on December 31, 2005. Secondary market investors now have a statutory right to sue public companies that operate in Ontario's capital markets for misleading disclosure or failure to make timely disclosure. Actions may be brought against the responsible issuer, directors and officers of responsible issuers and other controlling persons. Issuers must now be extra diligent to ensure that released documents and statements do not include misrepresentations. A detailed description of the regime was contained in the April 2005 edition of The Valuation Law Review.