CEDE v. TECHNICOLOR: THE SUPREME COURT RE-ILLUMINATES EXISTING LINES OF DELAWARE'S LEVEL PLAYING FIELD

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I. INTRODUCTION

With somewhat surprising regularity, the Supreme Court of Delaware (the court) is called upon to restate and re-emphasize certain basic concepts of Delaware corporate law and to root out changes that would become the law of Delaware if the opinions of the court of chancery were allowed to stand. Decisions such as *Smith v. Van Gorkom*,[1] *Paramount Communications, Inc. v. Time, Inc.*,[2] *Zirn v. VLI Corp.*,[3] *Nixon v. Blackwell*,[4] and *Mills Acquisition Co. v. MacMillan, Inc.*[5] are all examples of cases in which the court has found it necessary to shine its judicial light on existing boundaries of the Delaware level playing field so that the boundaries of the playing field are

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1. 488 A.2d 858 (Del. 1985).
2. 571 A.2d 1140 (Del. 1990).
3. 621 A.2d 773 (Del. 1993).
4. 626 A.2d 1366 (Del. 1993).
5. 559 A.2d 1261 (Del. 1989).

understood by the Delaware bench and bar, as well as the corporate world generally. In contrast, cases such as *Weinberger v. UOP, Inc.*,[6] *Unocal Corp. v. Mesa Petroleum Co.*,[7] and *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*[8] go beyond merely re-illuminating existing law and extend or modify some aspect of Delaware corporate law.

Cede & Co. v. Technicolor, Inc.[9] (*Cede II*) is a landmark case in which the court does some of both. The court restated the controlling Delaware case law and overruled, and hence eliminated, significant modifications to existing Delaware law that the court of chancery's opinion, if allowed to stand, would have made to Delaware corporate law as to both the duty of care and damages for breach of the duty of care. *Cede II* does not change existing law concerning the duty of care, however, the court did shine its judicial light on certain previously undefined aspects of the duty of loyalty.

Cede II was written by Justice Horsey for a three-judge panel of the five-man Delaware Supreme Court, consisting of himself, Justice Moore, and Justice Holland. *Cede II* has, of course, already been cited in Delaware corporate cases pending in the court of chancery and in the Delaware Supreme Court.[10]

The court's careful analysis of the case, the opinion of the court below, and the pertinent case law required a lengthy seventy-six page opinion. It does not make for light reading, even for those familiar with Delaware corporate law and cases. Because of the length

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6. 457 A.2d 701 (Del. 1983).

7. 493 A.2d 946 (Del. 1985).

8. 506 A.2d 173 (Del. 1986).

9. 634 A.2d 345 (Del. 1993). *Cede II* should be distinguished from *Cede I*, the earlier opinion on the plaintiff's interlocutory appeal. Cede & Co. v. Technicolor, Inc., 542 A.2d 1182 (Del. 1988) (*Cede I*). In *Cede I*, the court held that a dissenting shareholder was entitled to maintain a fraud action, as well as an appraisal action, and was not required to make an election of remedies prior to trial. *Id.* at 1188, 1191.

10. *E.g.*, *In re* Tri-Star Pictures, Inc. Litig., 634 A.2d 319 (Del. 1993). *Tri-Star* was argued September 22, 1992 but was not decided until November 24, 1993. The court said in *Tri-Star*: "Our disposition of these issues is basically determined by this Court's recent decision in *Cede & Co. v. Technicolor, Inc.*, Del. Supr., No. 336, 1991, slip op. (Nov. 1, 1993) (Horsey, J.), and our earlier decision of *Weinberger v. UOP*, Del. Supr., 457 A.2d 701 (1983)." *Tri-Star*, 634 A.2d at 321. In light of the fact that *Cede II* points out in detail why evidence of individual damage is not a required element for a claim of breach of fiduciary duty, it appears, the *Tri-Star* decision may have been deferred by the court until *Cede II* was decided. In *Cede II*, one specific issue was whether proof of harm is a required element of a claim for breach of the fiduciary duty of care. In *Tri-Star*, one issue was whether damages are an element of a claim for breach of the fiduciary duty of full disclosure.

of the opinion, and the care taken by the court to maintain the always delicate balance between the province of the trial court and the province of the appellate court, the decision may seem difficult to follow and understand from a casual first reading, especially since the court took the time and effort to show how most of the recent corporate cases fit together. *Cede II* has already been misunderstood, even by some knowledgeable Delaware corporate practitioners.

The purpose of this article is threefold: (a) to try to make the core decisions in *Cede II* clear and readily understandable, (b) to make it clear that *Cede II* does not change Delaware law, and (c) to point out the hidden magnitude and consequences of the changes in Delaware law comprehended in the Chancellor's now reversed opinion. In connection with the duty of care, the court stated plainly that the Chancellor had declined to follow *Van Gorkom* simply because the Chancellor believed that the *Van Gorkom* rule "unless modified, would lead to draconian results."[11] *Cede II*'s duty of care component can be tersely summed up as follows: what *Cede II* does, as the court's opinion plainly states, is to reaffirm *Van Gorkom* as to both liability and damages, and to direct the Chancellor to apply *Van Gorkom* (and other Delaware precedents).[12]

However, "doomsayers" of the bar in Delaware and elsewhere, as well as legal academia and the media, have already rolled their eyes to heaven in false alarm. They are incorrectly pronouncing, to those who find it easier to listen to such would-be legal pundits rather than taking the time and effort to read and understand what *Cede II* actually holds, that the *Cede II* decision has vastly enlarged the exposure of corporate directors in matters of due care, liability, and damages in Delaware merger and acquisition cases.[13] Actually,

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11. *Cede II*, 634 A.2d at 358.

12. *Id.* at 371. To understand *Cede II*, one must be familiar with *Van Gorkom*, which simply restated existing law on the duty of care. *See* William Prickett, *An Explanation of* Trans Union *to "Henny-Penny" and Her Friends*, 10 DEL. J. CORP. L. 451, 462 (1985) (noting that *Van Gorkom* only "restates the firm adherence of the Delaware courts" to the presumptions of the business judgment rule).

13. For example, in an article appearing in the *Wall Street Journal* on Monday, November 1, 1993, the headline states: "Court Holds Directors to Higher Standard." Richard B. Schmitt, *Court Holds Directors to Higher Standard*, WALL ST. J., Nov. 1, 1993, at B6. The foregoing statement is flatly incorrect. As will be shown, the duty of care standard has not changed one iota: on the contrary, it was the Chancellor's opinion that had sought to engraft radical changes on existing Delaware law. *See* discussion *infra* part V.

The lead paragraph of the Schmitt article is equally incorrect in stating, "The

as this article will show, a careful reading of the opinion itself makes it clear that *Cede II* does not change the law. Rather, the court has once again announced Delaware's firm adherence to preexisting case precedents (and in particular *Van Gorkom*) instead of adopting radical changes as to liability and damages that would have become the law of Delaware had the Chancellor's opinion been affirmed.[14] As can be seen, the Chancellor not only disregarded the court's directions on the procedural sequence to be followed[15] but, more importantly, altered existing Delaware law as it pertained to fiduciary obligations in corporate affairs, curtailed the applicable measure of damages, and elevated the business judgment rule from a rebuttable presumption to a substantive rule of law.[16] In other words, the court's opinion in *Cede II* not only preserves Delaware's level playing field but, by shining judicial light on basic corporate principles, has once again provided the Delaware bench, the corporate bar, and the corporate world with clearly visible lines and boundaries.

II. FACTUAL AND PROCEDURAL BACKGROUND

Cede II arose from a cashout merger in 1982-1983 of Technicolor with a wholly-owned subsidiary of MacAndrews & Forbes Group, Inc. (MAF).[17] This classic merger transaction consisted of the usual two steps: first, a tender offer at $23 per share, which the plaintiff did not accept, followed shortly thereafter by a cashout merger, again at $23 a share.[18] The plaintiff dissented and perfected its appraisal rights.[19]

Delaware Supreme Court has sent a tough new signal to corporate directors that they must provide shareholders maximum value when selling a public company." Schmitt, *supra*, at B6. In *Cede II*, there is no "new signal" at all. As this article will point out, what the court did in reversing the Chancellor and remanding the case to the court of chancery was to reaffirm existing Delaware case law rather than approving and adopting the drastic changes found in the Chancellor's opinion.

14. It is interesting to note that in his treatise on the business judgment rule, Dennis J. Block discusses the Chancellor's opinion as the law of Delaware. There are no references made to the appeal to the Delaware Supreme Court. *E.g.*, DENNIS J. BLOCK, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 24-26, 55, 167-70 (1993).

15. *Cede II*, 634 A.2d at 350 & n.2.

16. *Id.* at 350-51.

17. *Id.* at 349. Thus, it is important to note that the actions of the directors that are the subject of *Cede II* occurred *before* the decisions in both *Van Gorkom* and *Weinberger*, which were decided in March of 1985 and February of 1983, respectively.

18. *Id.*

19. *Cede II*, 634 A.2d at 349. *See* DEL. CODE ANN. tit. 8, § 262 (1991).

To carry out the merger, it was necessary for Technicolor to repeal the ninety-five percent shareholder super majority voting certificate provision in business combinations which Technicolor had previously adopted as an anti-takeover defense.[20] The certificate permitted repeal of the super majority provision by less than a ninety-five percent stockholder vote if such a repeal proposal were to be *unanimously* recommended by the entire Technicolor Board.[21] The Technicolor Board *appeared to have voted unanimously* to repeal the ninety-five percent certificate requirement, and eighty-nine percent of the Technicolor stockholders did vote in favor of the merger.[22] About two months after the merger, the plaintiff brought an appraisal action (the appraisal action) in the court of chancery.[23]

In January 1986, as a result of what the plaintiff had uncovered during discovery in the appraisal action, the plaintiff brought a second action against the Technicolor directors, alleging fraud, breach of fiduciary duty, and unfair dealing, and seeking rescissory damages (the personal liability action).[24] The defendants moved to dismiss the personal liability action.[25] The Chancellor denied the motion. The Chancellor also ruled that, after further discovery but prior to trial, the plaintiff would have to elect which action to pursue.[26]

The plaintiff filed an interlocutory appeal. The Delaware Supreme Court reversed in *Cede I*, ruling that the plaintiff was entitled to pursue both the appraisal action and the personal liability action concurrently through trial, and that both cases were to be consolidated for trial.[27] The court in *Cede II* pointed out that its opinion in *Cede I* had "twice" instructed the Chancellor to decide the personal liability case first, saying in a footnote:

> Therein we stated twice that if, in the consolidated proceedings, the court should determine that the merger "should not have occurred due to fraud, breach of fiduciary duty,

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20. Cinerama v. Technicolor, Inc., No. 8358, 1991 Del. Ch. LEXIS 105, at *13 (Del. Ch. June 21, 1991), *reprinted in* 17 DEL. J. CORP. L. 551, 560 (1992).

21. *Id.*

22. *Cede II*, 634 A.2d at 357-58.

23. *Id.* at 349. Cinerama petitioned the court of chancery for an appraisal under DEL. CODE ANN. tit. 8, § 262 (1991), in March of 1983. *Cede II*, 634 A.2d at 349.

24. *Cede II*, 634 A.2d at 349-50.

25. *Id.* at 350.

26. *Id.*

27. *Id.*

> or other wrongdoing on the part of the defendants, then Cinerama's appraisal action will be rendered moot and Cinerama will be entitled to receive rescissory damages."[28]

Following the consolidated trial, the Chancellor appeared to disregard the court's instructions in *Cede I* and proceeded to decide the appraisal action first.[29] The Chancellor then found that the appraisal value of the Technicolor shares was $21.60 per share, or $1.40 *less than* the cashout price of $23.00.[30]

The Chancellor then went on to decide the personal liability action. The Chancellor first decided the issue of the duty of loyalty in favor of the defendants.[31] Next, although he found five separate factual bases to support the plaintiff's claim of the breach of the duty of care,[32] the Chancellor found that the plaintiff had not met its burden of proof. This finding was based on the Chancellor's ruling that the duty of care included an additional requirement that the plaintiff also prove damages.[33] The Chancellor then pointed out that in the appraisal case, he, the Chancellor, had already determined that the plaintiff had not been damaged since the appraisal value of $21.60 was less than the $23 merger price.[34] The Chancellor, there-

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28. *Cede II*, 634 A.2d at 350 n.2 (quoting *Cede I*, 542 A.2d at 1191).

29. *Id.* at 350. This disregard by the Chancellor of the court's directions as to the sequence to be followed might appear at first glance to be innocuous and non-significant. Not so. The significance of the Chancellor's failure to decide the personal liability case first reoccurs throughout the court's opinion. Further, this reversal of sequence by the Chancellor turned out to be doubly significant and doubly incorrect on important legal matters.

30. *Cinerama*, No. 8358, 1991 Del. Ch. LEXIS 105, at *60, *reprinted in* 17 DEL. J. CORP. L. at 583-84. The Chancellor's reliance on his determination that the appraisal value of the Technicolor stock was only $21.60 was found by the court to be legally incorrect on two separate bases: (1) since the measure of damages in a fiduciary obligation case is not limited to the appraisal value of the stock, the Chancellor erred in capping the plaintiff's potential recovery; and (2) the plaintiff's damages may not be solely the difference between the appraisal price and the merger price, i.e., plaintiff may be entitled to rescissory damages or *Weinberger*-type damages. *Cede II*, 634 A.2d at 367; *See Weinberger*, 457 A.2d at 714.

31. *Cinerama*, No. 8358, 1991 Del. Ch. LEXIS 105, at *7, *reprinted in* 17 DEL. J. CORP. L. at 559.

32. *Cede II*, 634 A.2d at 369.

33. *Id.* at 370.

34. *Cinerama*, No. 8358, 1991 Del. Ch. LEXIS 105, at *60, *reprinted in* 17 DEL. J. CORP. L. at 583-84. Plaintiff appealed the Chancellor's $21.60 per share valuation, pointing out that the Chancellor's valuation was flawed by legal errors. The Supreme Court did not rule on plaintiff's contentions, holding that the appraisal appeal "and the issues raised therein" were "moot" by virtue of its decision in the personal liability case. *Cede II*, 634 A.2d at 351.

fore, dismissed the personal liability action, and the plaintiff appealed to the Supreme Court of Delaware.

III. THE COURT IN *CEDE II* CAREFULLY RESTRICTED ITS DECISIONS TO APPELLATE ISSUES

At the outset, four matters should be clearly understood. First, the court said at the beginning of its opinion in reciting the basic facts, "We borrow liberally from, and generally adopt, the Chancellor's findings."[35] In fact, the court was scrupulous in deferring throughout its opinion to the Chancellor's findings of fact.[36]

Second, the court itself did not make any final decisions, either as to liability or damages. For example, in its consideration of the duty of loyalty, the court pointed out that the Chancellor (and indeed the parties) had omitted any consideration of section 144[37] and of Technicolor's Certificate requirement of director unanimity to repeal Technicolor's ninety-five percent super majority vote.[38] The court did not itself go forward and decide the duty of loyalty as that duty relates to these omitted issues based on the record. Rather, the court remanded the case for further consideration by the Chancellor in light of the issues that the court pointed out had been omitted.[39] The court followed the same judicially conservative course in remanding to the Chancellor the duty of care aspect of the case. The court first pointed out that the Chancellor himself had found that the plaintiff had provided evidence of gross negligence on five different bases.[40] The court ruled that the Chancellor's addition of the requirement of proof of harm by the plaintiff as an element of the duty of due care was legally incorrect.[41] But, here again, the court did not arrogate to itself the function of the trial court—that is, of making the decision as to whether the merger was entirely fair to the plaintiff. Rather, the court, mindful of its limited role as an appellate court, remanded the case to the Chancellor for determination of liability. In the retrial, the directors will have the burden "to prove that the transaction was entirely fair."[42]

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35. *Cede II*, 634 A.2d at 351 n.3.
36. *E.g.*, *id.* at 360, 363, & 366.
37. DEL. CODE ANN. tit. 8, § 144 (1991).
38. *Cede II*, 634 A.2d at 365.
39. *Id.* at 366.
40. *Id.* at 369.
41. *Id.* at 371.
42. *Cede II*, 634 A.2d at 371 (citing *Van Gorkom*, 488 A.2d at 893; Shamrock

Third, the court ruled that the Chancellor had improperly capped the plaintiff's damages by limiting the amount recoverable to the difference between the excess of the appraised value of the shares over the cashout merger price.[43] Here, again, the court did not go forward and itself decide the measure of the plaintiff's damages based on the record: rather, just as it had done in *Weinberger*, the court remanded the damage issue to the Chancellor for consideration in light of the court's opinion.[44]

Finally, it should be noted that the court held that the appeal turned on the business judgment rule, saying: "The pivotal question in this case is whether the Technicolor [B]oard's decision of October 29 to approve the plan of merger with MAF was protected by the business judgment rule or should be subject to judicial review for its entire fairness."[45]

In none of the above aspects of the case can it be said that the court expanded existing areas of director liability under Delaware law or changed existing Delaware law as to the measure of damages. The court simply reversed the Chancellor where it found that the Chancellor had disregarded controlling Delaware case law or had added new requirements. The court was careful to restrict itself to its appellate function. Thus, the court has remanded the *Cede II* case to the Chancellor for reconsideration and clarification of the issues that the court pointed out had been overlooked or not dealt with by the Chancellor.[46]

IV. DUTY OF LOYALTY

The basic facts in *Cede II* that gave rise to the primary duty of loyalty issue were few and simple. The record established that the

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Holdings, Inc. v. Polaroid Corp., 559 A.2d 257, 271 (Del. Ch. 1989)). As mentioned below, it would seem that the defendants face an impossible task in that a breach of the duty of care has already been found. *Id.* at 370. The real issue would appear to be the relief to which plaintiff will be entitled.

43. *Id.* at 367.

44. *Id.* at 371.

45. *Id.* at 358.

46. The court also retained jurisdiction only as to the duty of disclosure, but remanded to the Chancellor for clarification as to the bases for the Chancellor's determination that Mr. Ryan's self- interest was not legally significant. *Cede II*, 634 A.2d at 373. In remanding on this issue, the court made it clear that the lower court's findings on the precise nature of Ryan's conflict must be stated, since it might be significant in terms of Technicolor's Certificate requirement of director unanimity in connection with the repeal of the super majority shareholder vote of 95%. *Id.*

Technicolor Board had agreed that one of the defendant directors, Mr. Sullivan, was to be paid a $150,000 finder's fee by Technicolor.[47] At least one other director, Mr. Ryan, also may have had a conflict of interest: he, in effect, had some sort of a promise of a position if the merger went through.[48] The Chancellor did not disclose his basis for finding that Mr. Ryan's undisclosed conflict was not material.[49]

The Chancellor held that to overcome the presumption of the business judgment rule in connection with the duty of loyalty, the plaintiff's burden of proving self-interest on the part of the directors in an arm's-length third-party transaction would be greater than that in a self-dealing transaction where directors stand on both sides of the transaction.[50] The required proof would be that such self-interest was material. To determine materiality, the Chancellor set up a two-prong test.[51] First, the Chancellor held that a director's self-interest is not material unless it is "sufficient to create a reasonable probability . . . that the independence of judgment of a 'reasonable person' in the director's position would be affected."[52] Second, the Chancellor held that to satisfy the requirement of materiality, the plaintiff would have to show that the director's individual self-interest tainted the collective decision of the Board as a whole.[53] Applying this two-pronged test, the Chancellor found proof of self-dealing sufficient to meet the first prong of the test due to director Sullivan's interest in the $150,000 finder's fee (and perhaps because of the unrevealed conflict of interest of the director, Mr. Ryan).[54] However, the Chancellor found there was insufficient evidence offered by the plaintiff to show that the self-interest of Sullivan (and possibly Mr. Ryan) was sufficient to have tainted the collective decision of the Board.[55] The Chancellor's decision as to the second prong appeared to the court to "be an apparent borrowing of precepts embodied in §144(a)"[56] without directly referring to or mentioning section 144. The basic

47. *Id.* at 357.
48. *Id.* at 356 n.18.
49. *Id.* at 372-73. The court also passed over the plaintiff's arguments that five directors had serious conflicts.
50. *Cede II*, 634 A.2d at 362.
51. *Id.* at 362-63.
52. *Id.* at 362.
53. *Id.*
54. *Cede II*, 634 A.2d at 362.
55. *Id.*
56. *Id.* at 365 (citing DEL. CODE ANN. tit. 8, § 144(a) (1991)).

rationale of section 144 is that the self-interest of a director will not vitiate board action if there is an independent, informed majority of the board.[57]

In remanding, the court did not change or enlarge the existing scope of the duty of loyalty. In all but one respect, discussed hereafter, the court affirmed the Chancellor's analysis and conclusions with respect to the duty of loyalty.[58] Specifically, the court affirmed the Chancellor's formulation of the first prong of the test as a correct statement of existing Delaware law on the duty of loyalty.[59] The court in doing so held that one director's self-interest or act of disloyalty is not sufficient per se to deprive the entire board of the presumption of loyalty stemming from the business judgment rule. The court stated:

> Cinerama misunderstands *Pogostin*. Nothing we said there suggests that one director's self-interest, or even an act of disloyalty by that director, so infects the entire process that the board itself is deprived of the benefit of the business judgment rule. This Court has never held that one director's colorable interest in a challenged transaction is sufficient, without more, to deprive a *board* of the protection of the business judgment rule presumption of loyalty. . . . Neither *Aronson* nor *Pogostin* can be fairly read to support Cinerama's thesis that a finding of one director's possession of a disqualifying self-interest is sufficient, without more, to rebut the business judgment presumption of director/board loyalty; and no Delaware decisional law of this Court supports such a result.[60]

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57. *Id.* In addition to an "independent informed majority of the board," § 144(a) also protects board actions if they are "disclosed to and approved by the [good faith vote of the] shareholders," or if the transaction is "found to be fair 'as to the corporation.'" *Id.* (quoting DEL. CODE ANN. tit. 8, § 144(a) (1991)).

58. *Cede II*, 634 A.2d at 363.

59. *Id.*

60. *Id.* at 363-64 (citations omitted). The court also noted:

> Provided that the terms of [section 144] are met, self-interest, alone, is not a disqualifying factor even for a director. To disqualify a director, for rule rebuttal purposes, there must be evidence of disloyalty. Examples of such misconduct include, but certainly are not limited to, the motives of entrenchment; fraud upon the corporation or the board; abdication of directorial duty; or the sale of one's vote.

Id. at 363 (citations omitted).

The court pointed out that it had declined to adopt a "bright line" test in cases of breach of duty of loyalty, agreeing with the defendants that such questions are fact dominated.[61]

However, the court also flatly rejected the Chancellor's adoption of a subjective standard in determining whether the plaintiff had met the first prong.[62] The court, in rejecting the Chancellor's reasonable person standard, said the standard was "unhelpful and, indeed, confusing."[63] Beyond that, the court stated that such a standard would be contrary to existing Delaware law.[64] The court apparently agreed with the plaintiff's point that the reasonable person test was not only a subjective test but was a tort concept not applicable to duty of loyalty cases.[65] The court further noted that the reasonable person test was inapplicable to a duty of loyalty claim.[66]

As to the second prong—that is, whether a director's individual self-interest affected the collective independence of the board—the court did not accept the Chancellor's formulation:

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61. *Id.* at 364. The court specifically stated that:

> [t]his Court has generally and consistently refrained from adopting a bright-line rule for determining when a director's breach of duty of independence through self-interest translates into evidence sufficient to rebut the business judgment presumption accorded board action. We agree with defendants that the question of when director self-interest translates into board disloyalty is a fact-dominated question, the answer to which will necessarily vary from case to case. A trial court must have flexibility in determining whether an officer's or director's interest in a challenged board-approved transaction is sufficiently material to find the director to have breached his duty of loyalty and to have infected the board's decision. Therefore, we reject Cinerama's contention that "any" found director self-interest, standing alone and without evidence of disloyalty, is sufficient to rebut the presumption of loyalty of our business judgment rule.

Id. (citations omitted).

62. *Cede II*, 634 A.2d at 364.

63. *Id.*

64. *See id.* at 364 n.31.

65. *Id.* at 359 n.26.

66. *Cede II*, 634 A.2d at 364 n.31. The court noted the lack of precision associated with a "reasonable" or "prudent" person test and further pointed out that even when such standards were adopted, it was in the context of the duty of care. *Id.* (citing Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963)). The court stated that "whatever the *Graham* standard may be, it has no applicability where there is a breach of the duty of loyalty." *Id.* (citing *Mills*, 559 A.2d at 1284 n.32). However, the court, while rejecting the "reasonable person" standard, did not state what would be the correct standard to apply. *Id.* at 364 (citing Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989); Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988)).

> We know of no Delaware decisional law which reflects this formulation or application of our business judgment rule's presumption of director loyalty as applied to a challenged third-party transaction; and the parties have not cited any authority supportive of the Chancellor's rationale.[67]

The court also stated that the proof necessary to establish a reasonable likelihood of lack of board independence was unclear from the Chancellor's opinion:

> The Chancellor ruled that, for purposes of rebutting the business judgment rule, any found director self- interest affecting director independence must also be found to have tainted, influenced or otherwise undermined the *board's* deliberative process. The Chancellor formulated the second part of the materiality test by stating:
> The preliminary or threshold question of independence is factual: is any differing financial interest sufficient to create a reasonable likelihood, considering all of the circumstances, that it actually affected the director*s*' actions to the corporation's detriment? In some instances an arguable or an established personal financial benefit may, when viewed in context, be found to be immaterial in fact to the exercise of a judgment motivated entirely to achieve the best available result for the corporation and (in the sale context) for its shareholders.
> It is unclear to us under this formulation precisely what a shareholder plaintiff would have to prove to demonstrate a reasonable likelihood of lack of board independence.[68]

The court pointed out that the requirements of the second prong were apparently borrowed from the statutory terms of section 144(a).[69] Section 144(a) deals with the circumstances in which there can be approval of a transaction which has been tainted by a director's self-interest if it is approved by a majority of disinterested directors. The court pointed out that neither the parties nor the Chancellor had considered the effect of section 144(a) in connection with the duty of loyalty in this context, saying:

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67. *Id.* at 363.

68. *Id.* at 364 (footnote omitted) (quoting *Cinerama*, No. 8358, 1991 Del. Ch. LEXIS 105, at *33-34, *reprinted in* 17 DEL. J. CORP. L. at 571).

69. *Id.* at 365.

> Largely without explanation, the Court of Chancery concluded that Sullivan's finder's fee, while materially affecting his own independent business judgment, was not a material interest affecting the transaction overall because the board had approved the transaction after Sullivan's interest had been disclosed. Section 144(a) may arguably sustain this finding. Unfortunately, neither the court below nor the parties have brought section 144(a) into their reasoning or analysis.[70]

The court noted that section 144(a)(1) might sustain the Chancellor's conclusion that the $150,000 finder's fee going to Mr. Sullivan did not adversely affect the Board's collective decision, since the receipt of the finder's fee was fully disclosed to and approved by the majority of the members of the Board, who otherwise were disinterested.[71] The court declined to decide the effect, if any, of section 144. Instead, the court remanded this question to the Chancellor for consideration.[72]

In addition, the court was critical of the parties and the Chancellor for failing to address the relevancy of Technicolor's ninety-five percent super majority voting provision required in business combinations.[73] Specifically, the court questioned whether the required unanimity by directors to repeal the ninety- five percent super majority stock vote provision could be valid since Mr. Sullivan (and perhaps Mr. Ryan) was tainted by self- interest:

> The question becomes whether, in light of Technicolor's charter requirement of director unanimity, the Chancellor's finding of board approval of the sale of Technicolor by an "overwhelming" vote of disinterested directors was sufficient to support a finding that the board had met its duty of loyalty. We decline to address this question in the first instance and until the implications of section 144(a) are addressed by the court below.[74]

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70. *Cede II*, 634 A.2d at 365 (citing Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976)).

71. *Id.* The court described § 144(a)(1) as a "legislative mandate" to remove "any taint" of director self-interest when there is "an approving vote of a majority of informed and disinterested directors." *Id.*

72. *Id.* at 366.

73. *Id.* at 365.

74. *Cede II*, 634 A.2d at 366. Thus, the court remanded the issue of loyalty saying:

> Those issues requiring resolution on remand relating to the duty of

The court has not dealt "broadbrush" with the duty of loyalty, nor has the court simply reversed the Chancellor, or enlarged the duty of loyalty. Rather, the court has carefully analyzed the entire legal situation implicating the duty of loyalty presented in the case and has remanded in the specific instances where the Chancellor erred, i.e., in imposing the reasonable person test. The court also determined that there were certain issues the court below (and indeed the parties) had omitted or not considered, i.e., section 144 and the Technicolor charter requirement of director unanimity. The court did not overstep its limited appellate function or transgress the trial functions of the court of chancery: rather, the court remanded for reconsideration to the lower court the duty of loyalty issue in the light of the supreme court's analysis and the applicable law. Thus, the opinion of the court in *Cede II* with regard to the duty of loyalty has created no new director liability. Indeed, the court has just restated and reenforced preexisting Delaware case law.

V. DUTY OF CARE

Turning to the duty of care, the court first held that the Chancellor had incorrectly held that the plaintiff's failure of proof on the duty of loyalty somehow lessened the significance of any dereliction in terms of the duty of care. The court stated:

> The court [of chancery] also reasoned that a judicial finding of director good faith and loyalty in a third-party, arms-length [sic] transaction should minimize the consequences of a board's *found* failure to exercise due care in a sale of a company. The Chancellor's rationale for subordinating the due care element of the business judgment rule, as applied to an arms-length [sic], third-party transaction, was a belief that the rule, unless modified would lead to draconian results. The Chancellor left no doubt that he was referring to this Court's decision in *Smith v. Van Gorkom.*

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loyalty are: (1) the precise standard of proof required under the second part of the materiality standard; (2) the legitimacy of such a standard under Delaware law and the relevance of section 144(a); (3) the effect of the unanimity requirement in Technicolor's charter on the duty of loyalty standard controlling this case; and (4) the consequence of an affirmance of the decision below finding no breach of the duty of disclosure on the question of director self-interest.

Id. (citation omitted).

> He stated, "In all, plaintiff contends that this case presents a compelling case for another administration of the discipline applied by the Delaware Supreme Court in *Smith v. Van Gorkom*."[75]

The court, in effect, again rejected the concept that a loyal director need not be a careful and prudent director, ("the pure heart and empty head defense"), and made it clear that the duty of care and the duty of loyalty have equal importance:

> The duty of the directors of a company to act on an informed basis, as that term has been defined by this Court numerous times, forms the duty of care element of the business judgment rule. Duty of care and duty of loyalty are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders. Each of these duties is of equal and independent significance.[76]

As to the duty of care, the court noted that the Chancellor made "at least five explicit predicate findings"[77] that the defendants were guilty of gross negligence. The court adopted these findings of fact regarding the duty of care, saying:

> We adopt, as clearly supported by the record, the Chancellor's presumed findings of the directors' failure to reach an informed decision in approving the sale of the company. We disagree with the Chancellor's imposition on

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75. *Id.* at 358-59 (citations omitted) (quoting *Cinerama*, No. 8358, 1991 Del. Ch. LEXIS 105, at *5, *reprinted in* 17 DEL. J. CORP. L. at 558).

76. *Id.* at 367 (citation omitted).

77. *Id.* at 369. The five bases may be summarized as follows: (1) There was no "prudent search for alternatives"; (2) Technicolor's directors had no basis to assume that a better offer from a third party could be expected following the public announcement; (3) "most of the directors had no knowledge of an impending sale of the company until they arrived at the meeting"; (4) "Perelman 'did, probably, effectively lock-up the transaction on October 29'"; and (5) the Board did not satisfy its obligations under *Revlon* "'to take reasonable steps in the sale of the enterprise to be adequately informed before it authorized the execution of the merger agreement.'" *Id.* (quoting *Cinerama*, No. 8358, 1991 Del. Ch. LEXIS 105, at *9, 66, 56, *reprinted in* 17 DEL. J. CORP. L. at 560, 587, 581).

Finally, the court said: "In addition, the Chancellor noted the relevance of *Revlon* in 'illuminat[ing] the scope of [the] board's due care obligations' and implied that the Technicolor board's failure to auction evidenced a breach of their duty of care." *Id.* at 369-70 (footnote omitted) (quoting *Cinerama*, No. 8358, 1991 Del. Ch. LEXIS 105, at *55, *reprinted in* 17 DEL. J. CORP. L. at 581) (citations omitted).

> Cinerama of an additional burden, for overcoming the rule, of proving that the board's gross negligence caused any monetary loss to Cinerama.[78]

The court then said that the issue in this case was the same as the issue in *Van Gorkom*:

> The question presented in this case is essentially the same as this Court was presented in *Van Gorkom*: whether the defendant directors, meeting as a board, satisfied the rule's presumption of board due care in meeting to consider for the first time a proposed sale of the company under terms negotiated exclusively by its chairman.[79]

Despite that fact, the Chancellor held that the plaintiff had to prove injury or harm as part of its burden of showing a violation of the duty of care.[80] Indeed, the Chancellor found that the plaintiff could not prove injury because the Chancellor had already decided in the appraisal action that the appraised value of the Technicolor stock was $21.60, some $1.40 below the cashout price of $23.[81]

The court soundly reversed the Chancellor as to his holdings on the duty of care. The court said:

> We think it is patently clear that the question presented is not one of first impression, as the Court below appears to have assumed. Applying controlling precedent of this Court, we hold that the record evidence establishes that Cinerama met its burden of proof for overcoming the rule's presumption of board duty of care in approving the sale of the company to MAF. The Chancellor's restatement of the rule—to require Cinerama to prove a proximate cause relationship between the Technicolor's board's presumed breach of its duty of care *and* the shareholder's resultant loss—is contrary to well-established Delaware precedent, irreconcilable with *Van Gorkom*, and contrary to the tenets of *Unocal* and *Revlon, Inc. v. MacAndrews & Forbes Holdings*. More importantly, we think the Court's restatement of the rule would lead to most unfortunate results, detrimental to

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78. *Cede II*, 634 A.2d at 370.
79. *Id.*
80. *Id.* at 368.
81. *Cinerama*, No. 8358, 1991 Del. Ch. LEXIS 105, at *60, *reprinted in* 17 DEL. J. CORP. L. at 583-84.

goals of heightened and enlightened standards for corporate governance of Delaware corporations.[82]

The court made it abundantly clear that it regarded the important changes made by the Chancellor to existing Delaware law unacceptable and inappropriate. The court thus reserved to itself the important task of revising the Delaware law when it is necessary to do so.[83] However, the court was careful to make it clear that its decision in no way lessened the broad protection of directors under the business judgment rule:

> Applying the rule, a trial court will not find a board to have breached its duty of care unless the directors individually and the board collectively have failed to inform themselves fully and in a deliberate manner before voting as a board upon a transaction as significant as a proposed merger or sale of the company. Only on such a judicial finding will a board lose the protection of the business judgment rule under the duty of care element and will a trial court be required to scrutinize the challenged transaction under an entire fairness standard of review.[84]

The court went on to point out that since the plaintiff had shown that the defendants had breached the duty of care, then the burden of proof shifted:

> The purpose of a trial court's application of an entire fairness standard of review to a challenged business trans-

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82. *Cede II*, 634 A.2d at 367 (citation omitted).

83. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 704 (Del. 1983).

84. *Cede II*, 634 A.2d at 368 (citations omitted). The court then said:

> The Chancellor held that "the questions of due care . . . need not be addressed in this case, because even if a lapse of care is assumed, plaintiff is not entitled to a *judgment on this record*." Having assumed that the Technicolor [B]oard was grossly negligent in failing to exercise due care, the [chancery] court avoided the business judgment rule's rebuttal by adding to the rule a requirement of proof of injury. The [chancery] court then found that requirement not met and, indeed, injury not provable due to its earlier finding of fair value for statutory appraisal purposes. In this manner, the court avoided having to determine whether the board had failed to "satisfy its obligation to take reasonable steps in the sale of the enterprise to be adequately informed before it authorized the execution of the merger agreement."

Id. (quoting *Cinerama*, No. 8358, 1991 Del. Ch. LEXIS 105, at *9, 56, *reprinted in* 17 DEL. J. CORP. L. at 560, 581).

> action is simply to shift to the defendant directors the burden of demonstrating to the Court the entire fairness of the transaction to the shareholder plaintiff, applying *Weinberger* and its progeny: *Rosenblatt v. Getty Oil Co.*, *Bershad v. Curtis-Wright Corp.*, and *Mills*. *Requiring the plaintiff to show injury through unfair price would effectively relieve director-defendants of establishing the entire fairness of the challenged transaction.*[85]

The court made it clear that the Chancellor was in error in applying *Barnes v. Andrews*,[86] a tort case decided by then District Court Judge Learned Hand rather than *Van Gorkom*, which was controlling Delaware precedent: "The Chancellor, without stating any reasons for not finding *Van Gorkom* to be controlling, chose instead to adopt the actionable negligence principles of *Barnes*."[87] The court noted that *Barnes* was "a seventy-year-old decision that none of the parties had relied on or felt pertinent."[88] The court also said:

> The Chancellor's reliance on *Barnes* is misguided. While *Barnes* may still be "good law," *Barnes*, a tort action, does not control a claim for breach of fiduciary duty. In *Barnes*, the court found no actionable negligence or proof of loss—and granted defendant's motion for a non-suit or grant of judgment for defendant on the merits. Here the Court was determining the appropriate standard of review of a business decision and whether it was protected by the judicial presumption accorded board action. The tort principles of *Barnes* have no place in a business judgment rule standard of review analysis.[89]

The court then pointed out that requiring proof of injury would be completely at odds with the purpose of the business judgment rule and would, if not reversed, elevate the business judgment rule from an evidentiary presumption into new substantive law:

> To inject a requirement of proof of injury into the rule's formulation for burden shifting purposes is to lose sight of

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85. *Id.* at 369 (citing Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985); Bershad v. Curtiss-Wright Corp., 535 A.2d 840 (Del. 1987); Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261 (Del. 1989) (emphasis added).

86. 298 F. 614 (S.D.N.Y. 1924).

87. *Cede II*, 634 A.2d at 370 (citation omitted) (footnote omitted).

88. *Id.* at 368.

89. *Id.* at 370-71 (footnote omitted).

> the underlying purpose of the rule. Burden shifting does not create *per se* liability on the part of the directors; rather, it is a procedure by which Delaware courts of equity determine under what standard of review director liability is to be judged. To require proof of injury as a component of the proof necessary to rebut the business judgment presumption would be to convert the burden shifting process from a threshold determination of the appropriate standard of review to a dispositive adjudication on the merits.[90]

The court concluded as to liability:

> In sum, we find the Court of Chancery to have committed fundamental error in rewriting the Delaware business judgment rule's requirement of due care. The court has erroneously subordinated the due care element of the rule to the duty of loyalty element. The court has then injected into the duty of care element a burden of proof of resultant injury or loss.[91]

The above review of the court's treatment of the duty of care shows that the court did not enlarge the duty of care. Rather, the court simply reaffirmed that *Van Gorkom*, itself an earlier restatement of the duty of care,[92] states the applicable Delaware standard of care. The court eliminated the lower court's incorrect subordination of

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90. *Id.* at 371. Obviously, since the Chancellor was found to be wrong in requiring proof of resultant injury or harm in the context of a duty of care, such a holding is equally applicable to co-equal duties of loyalty, disclosure, and good faith. Indeed, in *Tri-Star*, decided three weeks after *Cede II*, the court held:

> Our disposition of these issues is basically determined by this Court's recent decision in *Cede & Co. & Cinerama, Inc. v. Technicolor, Inc.*, Del. Supr., No. 336, 1991, slip op. (Nov. 1, 1993) (Horsey, J.), and our earlier decision of *Weinberger v. UOP*, Del. Supr., 457 A.2d 701 (1983). We find that the plaintiffs alleged sufficient individual injury resulting from the defendants' asserted manipulation of the Combination so as to dilute the cash value and impinge upon the voting rights of the minority's shares. Plaintiffs' claims clearly survive a motion to dismiss under Chancery Court Rule 12(b)(6). Such conduct, taken as true for present purposes, is a breach of the duty of loyalty requiring that the defendants' actions be judged by principles of entire fairness. Since this shifts the burden to the defendants to prove the "most scrupulous inherent fairness of the bargain," *Weinberger*, 457 A.2d at 710, there is no requirement that plaintiffs prove damages to survive a motion to dismiss.

Tri-Star, 634 A.2d at 321 (footnotes omitted).

91. *Cede II*, 634 A.2d at 371.

92. *See* Prickett, *supra* note 12.

the duty of care to the duty of loyalty, as well as the Chancellor's addition of the requirement of proof of harm. The Chancellor's changes, if not corrected, would have radically altered the whole concept of the business judgment rule, the duty of care, and the damages available to the plaintiff in a breach of the duty of care case.

The court also found that the Chancellor had committed error in "capping" the plaintiff's damages when the Chancellor held that, since the appraisal price was $21.60 and this was lower than the $23.00 cashout price, the plaintiffs had suffered no harm or damages.[93]

As to damages, the court concluded:

> In this regard, we emphasize that the measure of any recoverable loss by Cinerama under an entire fairness standard of review is not necessarily limited to the difference between the price offered and the "true" value as determined under appraisal proceedings. Under *Weinberger*, the Chancellor may "fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages." The Chancellor may incorporate elements of rescissory damages into his determination of fair price, if he considers such elements: (1) susceptible to proof; and (2) appropriate under the circumstances. Thus, we must reverse and remand the case to the trial court with directions to apply the entire fairness standard of review to the challenged transaction.[94]

Thus, on retrial in the court of chancery the defendants will have the burden of proving that the cashout price of $23 was entirely fair. In this connection, the plaintiff may be able to prove entitlement

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93. *Cede II*, 634 A.2d at 367. The court said as to damages:

> We also find the Court to have committed error under *Weinberger* in apparently capping Cinerama's recoverable loss under an entire fairness standard of review at the fair value of a share of Technicolor stock on the date of approval of the merger. Under *Weinberger*'s entire fairness standard of review, a party may have a legally cognizable injury regardless of whether the tender offer and cash-out price is greater than the stock's fair value as determined for statutory appraisal purposes.

Id. (citing *Weinberger*, 457 A.2d at 714; Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1104 (Del. 1985) (stating that appraisal is not plaintiff's exclusive remedy)).

94. *Id.* at 371 (quoting *Weinberger*, 457 A.2d at 714) (citations omitted).

to rescissory damages or the nominal type damages awarded in *Weinberger* to compensate them for a demonstrated wrong, even if the plaintiff cannot quantify the value of the wrong. In addition, the plaintiff is not limited to those measures of damage: the Chancellor has the broad authority to fashion any equitable or monetary relief that may be appropriate.

The court has not enlarged the measure of damages. Rather, the court reversed a decision which had fashioned a very restricted measure of damages based solely on the difference between the cashout price and what the Chancellor had determined to be the appraisal price. Such a decision would have disregarded the plaintiff's right to rescissory damages, *Weinberger*-type damages, and other equitable and/or monetary relief. Therefore, the court has simply reestablished the preexisting measure of damages.

The supreme court's directions to the Chancellor on remand of the due care issue may appear on first reading to differ from the directions on remand in *Van Gorkom*. The supreme court stated in *Van Gorkom* that:

> [o]n remand, the Court of Chancery shall conduct an evidentiary hearing to determine the fair value of the shares represented by the plaintiffs' class, based on the intrinsic value of Trans Union on September 20, 1980. Such valuation shall be made in accordance with *Weinberger v. UOP, Inc.* Thereafter, an award of damages may be entered to the extent that the fair value of Trans Union exceeds $55 per share.[95]

In *Cede II*, the court said: "We must reverse and remand the case to the trial court with directions to apply the entire fairness standard of review to the challenged transaction."[96]

Has the supreme court altered the law as set out in *Van Gorkom* without any explanation or articulating its reasons? Though the court has left a theoretical ambiguity, clearly the court has not altered *Van Gorkom*: the entire opinion is, in fact, a reaffirmation of *Van Gorkom*. In *Cede II*, on remand, it seems clear that the defendants legally

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95. *Van Gorkom*, 488 A.2d at 893 (citing *Weinberger*, 457 A.2d at 712-15).

96. *Cede II*, 634 A.2d at 371 (citing Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Shamrock Holdings v. Polaroid Corp., 559 A.2d 257 (Del. Ch. 1989)). *Shamrock Holdings* is not only consistent with but relies upon and cites the precise page of *Van Gorkom* where the Court remanded for a possible "award of damages." *Shamrock Holdings*, 559 A.2d at 271.

cannot now establish that the merger was entirely fair because the supreme court has specifically affirmed the Chancellor's factual findings establishing a breach of the director defendants' fiduciary duty of care.[97] Since the director defendants have breached their fiduciary duty of care, the merger obviously could not be the product of fair dealing. In other words, having "flunked"[98] fair dealing by breaching their duty of care, it would follow on remand that the defendants would not be able to establish entire fairness. Thus, the Chancellor would only "apply" the *entire* fairness standard to determine whether the defendants could sustain their burden of proving that they had not violated aspects of fair dealing, other than due care, as well as fair price. If the supreme court had meant to change the law as set out in *Van Gorkom*—altering the effect of a finding of a breach of fiduciary duty of care—it would have done so explicitly. Moreover, the directions on remand in *Cede II* specifically cited *Van Gorkom*.[99] Thus, it would appear that the supreme court's directions on remand were not intended to be different from or a change of *Van Gorkom*. In other words, the remand in *Cede II* will give the Chancellor the opportunity to determine (1) if the defendants can carry their burden of proof as to entire fairness (apart from due care), and (2) if the defendants can carry their burden of proof as to the entire fairness of the economic impact of the transaction. Thus, the primary issue on remand will be "fair price" which, under *Weinberger*, includes "elements of rescissory damages" and whatever other type of damages plaintff can show.[100] To the extent defendants fail to overcome their burden on other aspects of fair dealing evidence and thus prove additional aspects of unfair dealing, such proof may be another factor on which the chancellor may rely in exercising his broad equitable discretion in fashioning whatever form of equitable or monetary relief he determines is appropriate under all the circumstances.

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97. *Cede II*, 634 A.2d at 370.

98. Weinberger v. UOP, Inc., No. 5642, slip op. at 14 (Del. Ch. Apr. 24, 1984), *reprinted in* 9 DEL. J. CORP. L. 502, 510-11 (1984) (finding that "the defendants have already flunked the [entire fairness] test since they have not passed the fair dealing requirement").

99. *Cede II*, 634 A.2d at 371; *see also id.* at 370 ("The trial court's presumed findings of fact of board breach of duty of care clearly brought the case under the controlling principles of *Van Gorkom* and its holding that the defendant board's breach of its duty of care required the transaction to be reviewed for its entire fairness.").

100. *Weinberger*, 457 A.2d at 712-15.

VI. CONCLUSION

Though often overlooked by legal academics, the fact is that a legal case is actually a dispute between legal adversaries. Thus, the primary function of the court is to adjudicate the dispute as it relates to them. The explanation to the legal world in general is, in a very real sense, secondary to the adjudication between the parties, but nevertheless important.

In conclusion, therefore, it is appropriate to turn to the case between the parties. Where does *Cede II* leave the parties? The case has been remanded to the court of chancery with directions to reconsider the case in light of issues that were omitted by the court of chancery and the parties, and also to reconsider the case in light of the reversals on points of law.

Probably most important, from the point of view of the plaintiff at least, was the fact that the court has found, based on the Chancellor's own findings, that the plaintiff has established a violation of the duty of care. As a practical matter, on remand, the defendants face the impossible task of now trying to show that they can meet the stringent test of entire fairness, including fair dealing and an entirely fair price which, under *Weinberger*, can include "any damages, resulting from the taking"[101] as well as "elements of rescissory damages."[102] In reality, the sole issue remaining for disposition by the Chancellor is the determination of the "fair price." In other words, the court will have to determine damages in the light of *Weinberger* and the court's instruction in *Cede II*.

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101. *Id.* at 713.
102. *Id.* at 714.