VALUATION LITIGATION

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INTRODUCTION

Valuation issues can arise in many diverse types of litigation, from corporate mergers to divorce proceedings and, in each respective context, the issues often are very complex. For an example of this complexity, one need look no further than the Delaware Supreme Court's October 1996 opinion in *Cede & Co. v. Technicolor, Inc.*,[1] a stockholder valuation and statutory appraisal action threatening to become the modern day equivalent of Bleak House. The Delaware Supreme Court reversed the court of chancery and remanded the case for a recalculation of the "fair value" of the shares of the stockholders of the target corporation whose interests were eliminated in exchange for cash in a two-step merger. This yet to be resolved appraisal action was originally filed in March 1983, more than fourteen years ago and has already been the subject of several appeals to the Delaware Supreme Court as well as a forty-seven day trial in the court of chancery.

This article is intended to provide an overview of valuation issues. It includes a discussion of stockholder appraisal actions, breach of fiduciary duty actions against corporations and their officers and directors, actions for fraud and breach of contract arising principally out of acquisitions, reorganizations under the Bankruptcy Code, and tax proceedings. Part I discusses how valuation disputes arise in each context, the legal standards that are applicable to each claim, and the different legal and financial standards that are applied to the actual valuation calculation in the different proceedings. Part II provides an overview of some selected valuation methodologies. Part III discusses the adjustments that may have to be made to the valuation of a stockholder's interest, such as a downward adjustment to account for a

[1] 684 A.2d 289 (Del. 1996).

minority interest and lack of control or an upward adjustment to account for voting control, otherwise referred to as a control premium.

I. VALUATION DISPUTES

A. *Statutory Appraisal Proceedings*

1. Delaware Law

During merger negotiations there exists the potential for abuse by majority stockholders[2] who can dictate the terms of the transaction, including price. The substantial interests that are at stake in such transactions are evidenced by the fact that in just the past ten years, approximately $2.5 trillion has been involved in mergers and other business combinations,[3] and a large portion was paid to minority stockholders[4] in exchange for their interests. Because of the potential for abuse, significant statutory and judicial protections have been created for the minority holders.

The four most common types of mergers are the standard two-party, multi-party, triangular, and reverse triangular mergers.[5] The mechanics of these transactions are as follows:

- Two-Party Merger: Corporation A (acquiror) acquires corporation T (target) by merging T into A, which is the

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[2]References to "majority stockholder" includes those stockholders with a majority interest in a corporation (i.e., owns or controls more than 50% of the stock) as well as those stockholders who are able to dictate management. *See also* BLACK'S LAW DICTIONARY 955 (6th ed. 1990) ("majority stockholder" means "[o]ne who owns or controls more than 50 percent of the stock of a corporation, though effective control may be maintained with far less than 50 percent if most of the stock is widely held").

[3]*See* 1995 M&A PROFILE, 30 MERGERS & ACQUISITIONS 37 (Mar./Apr. 1996) (No. 5). In 1996, merger and acquisition activity set new records. In the United States there was $659 billion of merger activity (up 27% from $519 billion in 1995) and $1.14 trillion deals worldwide. Steven Lipin, *Gorillas in Our Midst: Megadeals Smash Records as Firms Take Advantage of Favorable Climate*, WALL ST. J., Jan. 2, 1997, at R8.

[4]References to "minority stockholder" includes those stockholders with a minority interest in a corporation (i.e., owns or controls less than 50% of the stock) as well as those stockholders who are unable to influence management. *See also* BLACK'S LAW DICTIONARY 997 (6th ed. 1990) ("minority stockholder" means "[t]hose stockholders of a corporation who hold so few shares in relation to the total outstanding that they are unable to control the management of the corporation or to elect directors").

[5]1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS §§ 9.4-9.7, at 9-10 to 9-13 (2d ed. Supp. 1995).

surviving corporation. The shares of stock of T are converted into stock or other securities of A, cash, or another form of permissible consideration. All of the assets and liabilities of T become assets and liabilities, respectively, of A.

- Triangular Merger: Corporation A forms a subsidiary, S, into which T is merged. A is the sole stockholder of S and votes all of its stock in favor of the merger. The effect is that T is merged into S, a wholly-owned subsidiary of A, and the outstanding shares of S, which remain outstanding, as well as the shares of A, are unaffected by the merger. The shares of stock of T outstanding immediately prior to the effective time of the merger are converted into stock or other securities of A, cash, or another form of permissible consideration.

- Reverse Triangular Merger: The merger is effectuated in the same manner as a triangular merger, except that S is merged into T.

- Multi-Party Merger: Two corporations, T1 and T2, merge into a third corporation, A, which is often created solely to perfect the merger transaction. The effect is that T1 and T2 become part of A.

In the State of Delaware,[6] the merger provisions of the Delaware General Corporation Law permit the majority stockholders to "cash-out"[7]

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[6]The majority of this article focuses on Delaware because a large portion of the biggest mergers have been governed by Delaware law due to the fact that "[o]ver 40 percent of the companies listed on the New York Stock Exchange are incorporated in Delaware." Leo Herzel & Laura D. Richman, *Foreword* to *id.* at F-1. A majority of Fortune 500 business entities are incorporated in Delaware. *Id.*

[7]The term "cash-out" has been used to describe the situation that occurs when the majority forces the minority to accept a nonnegotiable price for their stock and, thus, involuntarily divests them of their equity in exchange for cash. Joseph E. Calio, *New Appraisals of Old Problems: Reflections on the Delaware Appraisal Proceeding*, 32 AM. BUS. L.J. 1, 2-3 nn.7-8 (1994). *See also Weinberger v. UOP, Inc.*, 457 A.2d 701, 703 (Del. 1983) (using term "cash-out"). Terms such as "freeze-out" or "squeeze-out" have also been ascribed to this situation. *See, e.g.*, Richard A. Booth, *The New Law of Freeze-Out Mergers*, 49 MO. L. REV. 517, 517-18 n.2 (1984) ("freeze-out"); Dierdre A. Burgman & Paul N. Cox, *Reappraising the Role of the Shareholder in the Modern Public Corporation; Weinberger's Procedural Approach to Fairness in Freezeouts*, 1984 WIS. L. REV. 593, 594 (1984)

the minority stockholders.[8] If the minority stockholders are "cashed-out," one way that the Delaware General Corporation Law protects such stockholders is by providing them with the statutory remedy of appraisal.[9] An appraisal proceeding is a legislative remedy in which a judicial determination is made of the "fair value" of a corporation's shares for those stockholders who dissent[10] from a merger alleging inadequacy of the offering price.[11] Delaware's appraisal statute provides:

> Any stockholder of a corporation of this State who holds shares of stock on the date of the making of a demand pursuant to subsection (d) of this section with respect to such shares, who continuously holds such shares through the effective date of the merger or consolidation, who has otherwise complied with subsection (d) of this section and who has neither voted in favor of the merger or consolidation nor consented thereto in writing pursuant to § 228 of this title shall be entitled to an appraisal by the Court of Chancery of the fair value of his shares of stock under the circumstances described in subsections (b) and (c) of this section.[12]

("freezeout"); Marc I. Steinberg & Evalyn N. Lindahl, *The New Law of Squeeze-out Mergers*, 62 WASH. U. L.Q. 351 (1984) ("squeeze-out"); Charles W. Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares*, 65 NOTRE DAME L. REV. 425, 425 n.4 (1990) (using "freeze-out" when stockholders retain equity interests but are deprived of employment or dividends and "squeeze-out" when stockholders are forced to give up equity for cash).

[8]*See* DEL. CODE ANN. tit. 8, §§ 251-254, 257, & 263 (1991 & Supp. 1994). The option of the majority to "cash-out" the minority is not expressly set forth in Delaware's General Corporation Law but is permitted because the applicable statutory language allows cash to be used as consideration in a merger transaction. *See* DEL. CODE ANN. tit. 8, §§ 251(b), 252(b), 253(a), 254(c), 257(b), & 263(b) (1991 & Supp. 1994).

[9]DEL. CODE ANN. tit. 8, § 262 (Supp. 1994). Appraisal rights under Delaware law were first created in 1899. *See* 21 Del. Laws 273, § 56 (1899).

[10]Appraisal rights are available only to stockholders who have not voted in favor of or otherwise consented to a merger. DEL. CODE ANN. tit. 8, § 262(a) (Supp. 1994); *see Cede & Co.*, 684 A.2d at 296.

[11]*Cede & Co.*, 684 A.2d at 296 (citation omitted); Cede & Co. v. Technicolor, Inc. (Technicolor I), 542 A.2d 1182, 1186 (Del. 1988) (citing *Weinberger*, 457 A.2d at 714; Kaye v. Pantone, Inc., 395 A.2d 369, 374-75 (Del. Ch. 1978)).

[12]DEL. CODE ANN. tit. 8, § 262(a) (Supp. 1994). "Fair value" has been interpreted to mean compensation for the intrinsic value of the stock that has been taken from the stockholder, "viz., his proportionate interest in a going concern." Tri-Continental Corp. v. Battye, 74 A.2d 71, 72 (Del. 1950). *See also* Rapid-American Corp. v. Harris, 603 A.2d 796, 802 (Del. 1992) (dissenting shareholders are entitled to receive "'fair value' representing their 'proportionate interest in a going concern'"); Cavalier Oil Corp. v. Harnett, 564 A.2d 1137,

In an action under Delaware's appraisal statute, the only litigable issue is the value of the appraisal petitioners' shares on the date of the merger, the only defendant is the surviving corporation, and the only relief is a judgment for the fair value of the petitioners' shares.[13] An appraisal is the exclusive remedy when the only challenge to a merger is price.[14]

The right to an appraisal applies only to specified mergers or consolidations[15] and, thus, does not apply to stock options, a sale or transfer of assets, dissolution, or charter amendments.[16] Additionally,

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1144 (Del. 1989) (same).

[13]*Cede & Co.*, 684 A.2d at 296 (citing *Technicolor I*, 542 A.2d at 1187).

[14]*Technicolor I*, 542 A.2d at 1186; *Kaye*, 395 A.2d at 375; Cooper v. Pabst Brewing Co., No. 7244, 1993 Del. Ch. LEXIS 91, at *6 (Del. Ch. June 8, 1993) ("The appraisal remedy under 8 *Del. C.* § 262 is the exclusive remedy available to a minority shareholder in a cash-out merger whose only grievance is the inadequacy of the price which he has been offered for his shares.").

The remedy of appraisal is even more important since the United States Supreme Court has refused to extend the protections of the federal securities laws to stockholders alleging unfair price in a cash-out merger. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) (refusing to displace state corporate law appraisal remedy for additional relief under Rule 10b-5).

[15]Appraisal rights are only provided for mergers or consolidations set forth in the Delaware Corporate Code. *See* DEL. CODE ANN. tit. 8, §§ 251-254, 257-258, & 263 (1991 & Supp. 1994). These sections are titled as follows: merger or consolidation of domestic corporations (§ 251); merger or consolidation of domestic and foreign corporations (§ 252); merger of parent corporation and subsidiary or subsidiaries (§ 253); merger or consolidation of domestic stock and non-stock corporations (§ 257); merger or consolidation of domestic and foreign stock and nonstock corporations (§ 258); and merger or consolidation of domestic corporations and limited partnerships (§ 263).

Some states provide an appraisal remedy in transactions other than mergers and consolidations. *See, e.g.*, N.J. STAT. ANN. § 14A:11-1(1)(B) (West 1996) (providing stockholders the right to dissent and receive appraisal for "sale, lease, exchange or other disposition of all or substantially all of the assets"); N.Y. BUS. CORP. LAW § 910(a)(1)(b) (McKinney 1986) (granting appraisal rights to stockholders who do not consent to the "sale, lease, exchange or other disposition of all or substantially all of the assets of a corporation"); N.Y. BUS. CORP. LAW § 806(b)(6)(A) (McKinney 1986) (appraisal rights for preferred stockholders when preferential right or sinking fund provision is altered).

[16]*See, e.g.*, Tanzer v. International Gen. Indus., Inc., 402 A.2d 382 (Del. Ch. 1979) (no appraisal for sale of assets); Lichtman v. Recognition Equip., Inc., 295 A.2d 771 (Del. Ch. 1972) (no appraisal for stock options extinguished in merger); Hariton v. Arco Elecs., Inc., 182 A.2d 22 (Del. Ch. 1962), *aff'd*, 188 A.2d 123 (Del. 1963) (no appraisal for sale of assets). The statute does, however, permit a corporation to grant a stockholder, in its certificate of incorporation, appraisal rights in the excluded situations. *See* DEL. CODE ANN. tit. 8, § 262(c) (1991) ("[a]ny corporation may provide in its certificate of incorporation that appraisal rights under this section shall be available for the shares . . . [for] any merger or consolidation in which the corporation is a constituent corporation or the sale of all or substantially all of the assets of the corporation").

appraisal rights are granted only to a "holder of record"[17] and there is no right to an appraisal for a class or series of shares if the class or series is listed on a national securities exchange or held of record by more than 2,000 stockholders, unless the terms of the proposed merger or consolidation would require the stockholders to accept some form of consideration other than stock (i.e., bonds, cash, rights, or property).[18] In order to perfect the right to an appraisal, a stockholder must make a written demand for an appraisal prior to the merger[19] and file an appraisal petition with Delaware's Court of Chancery within 120 days after the effective date of the merger.[20]

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[17]DEL. CODE ANN. tit. 8, § 262(a) (Supp. 1994). The "holder of record" is the person in whose name the shares are registered on the corporation's records or stock ledger. While there is no express requirement for a corporation to maintain a stock ledger, the requirement has been implied. *See* Rainbow Navigation, Inc. v. Pan Ocean Navigation, Inc., 535 A.2d 1357, 1359 (Del. 1987) (citing DEL. CODE ANN. tit. 8, §§ 219-220). If a corporation fails to maintain a stock ledger, it may be estopped from asserting that the appraisal petitioner does not have record holder status. *Id.*

The definition of "stockholder" under § 262 has been strictly construed and the Delaware courts leave no room for exceptions. *See* Enstar Corp. v. Senouf, 535 A.2d 1351, 1356 (Del. 1987) (court refused to grant appraisal rights because record owner neglected to demand an appraisal). In *Enstar*, the stock was held in the name of the brokerage firm instead of the customer's name. *Id.* at 1353. The customer notified the corporation of her desire for an appraisal. *Id.* However, her brokerage firm, the actual "holder of record," never requested an appraisal. *Id.* The Delaware Supreme Court refused to allow the customer's notice of dissent to satisfy the notice requirements of the appraisal statute. *Id.* at 1355. *See also* Raynor v. LTV Aerospace Corp., 331 A.2d 393, 394 (Del. Ch. 1975) (holding that record holder's failure to object to merger in writing barred equitable owner from perfecting appraisal rights). The rationale for this strict construction is to ensure certainty in that the majority can accurately calculate the number of minority stockholders simply by checking the corporate ledger. *See Enstar*, 535 A.2d at 1356 ("[a]ny other result would embroil merging corporations in a morass of confusion and uncertainty"). It must be noted, however, that record holders demanding an appraisal are not required to prove that they were authorized by the beneficial owner. Olivetti Underwood Corp. v. Jacques Coe & Co., 217 A.2d 683, 688 (Del. 1966) (holding brokers "are not required to prove their authority and are eligible to seek appraisal"). Similarly, a trustee holding stock for two beneficiaries may be able to vote one beneficiary's shares for the merger and demand an appraisal of the remaining shares. Reynolds Metals Co. v. Colonial Realty Corp., 190 A.2d 752, 755 (Del. 1963) (recognizing broker's right to split vote and seek appraisal for some shares).

[18]DEL. CODE ANN. tit. 8, § 262(b)(2)a-d (Supp. 1994); *see* Klotz v. Warner Communications, Inc., No. 11,633, 1995 Del. Ch. LEXIS 52, at *4 (Del. Ch. May 8, 1995), *reprinted in* 20 DEL. J. CORP. L. 1098, 1100 (1995), *aff'd*, 674 A.2d 878 (Del. 1995).

[19]DEL. CODE ANN. tit. 8, § 262(d)(1) (1991) ("A stockholder electing to take such action must do so by a separate written demand as herein provided.").

[20]DEL. CODE ANN. tit. 8, § 262(e) (1991). Importantly, a stockholder cannot vote in favor of a merger if he or she intends to preserve his or her appraisal rights. DEL. CODE ANN. tit. 8, § 262(b)(1) (Supp. 1994); *see Lichtman*, 295 A.2d at 772. However, it is not necessary for a stockholder to vote against the proposed merger. Lewis v. Corroon & Reynolds Corp.,

2. Appraisal Standard — Fair Value

Under Delaware's appraisal statute, dissenting stockholders are entitled to receive the "fair value" of their shares on the date of the merger[21] with the objective being to provide them with the financial equivalent of what has been taken from them.[22] It has been long-recognized that "fair value" does not mean "fair market value" as market value is not determinative of price in an appraisal proceeding.[23]

Courts have defined the statutory term "fair value" as follows:

> The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern. By value of the stockholder's proportionate interest in the corporate enterprise is meant the true or intrinsic value of his stock which has been taken by the merger. In determining what figure represents this true or intrinsic value, the appraiser and the courts must take into

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57 A.2d 632, 633 (Del. Ch. 1948).

[21]DEL. CODE ANN. tit. 8, § 262(a) (Supp. 1994). A plaintiff is not required to choose between an appraisal action and a breach of fiduciary duty action. *Technicolor I*, 542 A.2d at 1190. In *Technicolor I*, the court of chancery held that the plaintiff had to make such a selection at the time of trial. *Id.* The Delaware Supreme Court reversed, stating that "[t]he 'duty' that the Court was alluding to implicates the doctrine of election of remedies, but the doctrine has no application in this case." *Id.* The court rationalized that had the plaintiff "known at the time of the merger what it arguably learned through discovery, it is reasonable to assume that [the plaintiff] would have first brought suit to enjoin the merger, and if unsuccessful, [the plaintiff] could still have perfected its appraisal rights." *Id.* at 1191. Along the same lines, the Delaware Supreme Court has also stated in *Weinberger*:

> While a plaintiff's monetary remedy ordinarily should be confined to the more liberalized appraisal proceeding herein established, we do not intend any limitation on the historic powers of the Chancellor to grant such other relief as the facts of a particular case may dictate. The appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved. Under such circumstances, the Chancellor's powers are complete to fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages. Since it is apparent that this long completed transaction is too involved to undo, and in view of the Chancellor's discretion, the award, if any, should be in the form of monetary damages based upon entire fairness standards, i.e., fair dealing and fair price.

Weinberger, 457 A.2d at 714 (citation omitted).

[22]*Cede & Co.*, 684 A.2d at 298.

[23]Chicago Corp. v. Munds, 172 A. 452, 453-54 (Del. Ch. 1934).

> consideration all factors and elements which reasonably might enter into the fixing of value. Thus, market value, asset value, dividends, earning prospects, the nature of the enterprise and any other facts which were known or which could be ascertained as of the date of merger and which throw any light on future prospects of the merged corporation are not only pertinent to an inquiry as to the value of the dissenting stockholders' interest, but must be considered by the agency fixing the value.[24]

In calculating fair value, the objective is to provide the dissenting stockholder with his or her "proportionate share of fair value in the *going concern* on the date of the merger, rather than value that is determined on a liquidated basis."[25] This means valuing the corporation "as if the merger had never been conceived."[26] Thus, the corporation must first be valued as an entity and then a stockholder's proportionate interest is determined after such a valuation.[27] Fair value is determined as of the date of the merger, and events subsequent to the merger are not taken into account in determining fair value.[28] In this regard, Delaware's appraisal statute provides that the court:

> shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with a fair rate of interest, if any, to be paid upon the amount determined to be the fair value. In

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[24]Tri-Continental Corp. v. Battye, 74 A.2d 71, 72 (Del. 1950).

[25]*Cede & Co.*, 684 A.2d at 298 (citing Bell v. Kirby Lumber Corp., 413 A.2d 137, 142 (Del. 1980)). The fair value was initially determined by extracting the true value of a shareholder's interest in the company. *See In re* Shell Oil Co., 607 A.2d 1213, 1219 (Del. 1992); *Technicolor I*, 542 A.2d at 1186; Rosenblatt v. Getty Oil Co., 493 A.2d 929, 942 (Del. 1985); Rothschild Int'l Corp. v. Ligget Group, Inc., 474 A.2d 133, 137 (Del. 1984). *See also Tri-Continental Corp.*, 74 A.2d at 72 (valuing stock on the date of the merger); Kahn v. Household Acquisition Corp., No. 6293, 1988 Del. Ch. LEXIS 64, at *40-41 (Del. Ch. May 6, 1988), *reprinted in* 14 DEL. J. CORP. L. 343, 364 (1989) (assessing the value of stock at the time of merger).

[26]*Chicago Corp.*, 172 A. at 455.

[27]*See, e.g., Cede & Co.*, 684 A.2d at 298 (asserting that "the company must first be valued as an operating entity"); Kleinwort Benson Ltd. v. Silgan Corp., No. 11,107, 1995 Del. Ch. LEXIS 75, at *6 (Del. Ch. June 15, 1995), *reprinted in* 20 DEL. J. CORP. L. 1079, 1084 (1995) ("The expert should value the entire corporation as a going concern, then allocate that value pro rata among the shareholders.").

[28]*Technicolor I*, 542 A.2d at 1187.

> determining such fair value, the Court shall take into account all relevant factors.[29]

Notwithstanding this statutory language, the Delaware Supreme Court in *Weinberger v. UOP, Inc.* held that elements of future value may be a factor to the extent they are "known or susceptible of proof as of the date of the merger and not the product of speculation."[30]

Recently, the Delaware Supreme Court, in *Cede & Co. v. Technicolor, Inc.*,[31] clarified the reconciliation of its holding in *Weinberger* with the appraisal statute. Technicolor Incorporated (Technicolor) was a corporation in the film/audio-visual industry, whose market share and earnings stagnated by the early 1980s.[32] In May 1981, Technicolor's Board of Directors approved the implementation of a long-

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[29]DEL. CODE ANN. tit. 8, § 262(h) (1991). Section 262(h) also provides the court with discretion to allow discovery. *See, e.g.*, Cede & Co. v. Technicolor, Inc., No. 7129, 1984 WL 8247, at *1 (Del. Ch. Oct. 22, 1984), *reprinted in* 10 DEL. J. CORP. L. 158, 161 (1985) ("It is conceded that plaintiffs have qualified for an appraisal of their stock . . . and that to this end they are entitled to discovery."); Ross v. Proco Management, Inc., No. 6146, 1983 WL 17991, at *2 (Del. Ch. May 25, 1983) ("[T]he proper criterion as to the scope of the discovery is whether the discovery sought is reasonably calculated to lead to admissible evidence as to the value as of the date of the merger."); Kahn v. Household Acquisition Corp., No. CIV.A.6293, 1983 WL 103279, at *1 (Del. Ch. Apr. 26, 1983) (granting plaintiff's motion to compel discovery of financial and internal matters); Kaye v. Pantone, Inc., No. 5466, 1981 WL 15072, at *1 (Del. Ch. Oct. 6, 1981) (noting that because defendant conceded that plaintiff was a valid appraisal petitioner, plaintiff was "therefore entitled to any discovery which reasonably relates to the issue of the value of the . . . shares"); Machovec v. Reserve Oil Co., No. 5162, 1979 WL 6163, at *1 (Del. Ch. May 17, 1979) (prohibiting a requested production that was not "reasonably calculated" to lead to discovery of admissible evidence). In this regard, the Delaware Supreme Court has stated that

> the majority may have insight into their company's future based primarily on bits and pieces of *nonmaterial* information that have value as a totality. It is this information that, if available in a statutory appraisal proceeding, the Court of Chancery must evaluate to determine if future earnings will affect the fair value of shares on the day of the merger. To obtain this information the appraisal petitioner must be permitted to conduct a "detailed investigation into the facts that is warranted by the acute conflict of interest and the potential for investor harm that is inherent in freezeout transactions.

Technicolor I, 542 A.2d at 1187 n.8 (quoting ROBERT C. CLARK, CORPORATE LAW 508 (1986)).

[30]*Weinberger*, 457 A.2d at 713. Similarly, management's protections are not considered unless they are susceptible of proof as of the merger date. *See Kleinwort*, 1995 Del. Ch. LEXIS 75, at *21-22, *reprinted in* 20 DEL. J. CORP. L. at 1091. *See also* Lane v. Cancer Treatment Ctrs. of Am., Inc., No. 12,207, 1994 Del. Ch. LEXIS 67, at *10 (Del. Ch. May 25, 1994) (post-merger performance used to assess reasonableness of premerger protections by management).

[31]684 A.2d 289 (Del. 1996).

[32]*Id.* at 291.

term growth plan devised by its Chief Executive Officer and Board Chairman, Morton Kamerman (the Kamerman Plan).[33] However, Technicolor's September 1982 financial statements (for the fiscal year ending June 1982) reported an eighty percent decline in income.[34] Shortly thereafter, the MacAndrews & Forbes Group Incorporated (MAF), at the initiation of its controlling stockholder, Ronald O. Perelman, proposed an acquisition of Technicolor under a two-step plan by which MAF would first make a tender offer at $23 per share for all outstanding shares of Technicolor's common stock, and then by merger, Technicolor would become a wholly owned subsidiary of MAF with the remaining outstanding shares being converted into $23 per share.[35] Technicolor's Board approved and recommended the plan to its stockholders in late October 1982. The stockholders approved the plan, and in November 1982, MAF commenced an all-cash tender offer of $23 per share to the stockholders of Technicolor. When the tender offer closed on November 30, 1982, MAF had acquired control of Technicolor. By December 3, 1982, MAF had acquired 82.19% of Technicolor.[36] The merger was accomplished on January 24, 1983, and an appraisal petition was filed by March 1983.[37] The parties to the proceeding agreed that the appraised value of Technicolor was to be fixed as of January 24.[38]

Significantly, the court of chancery made the following findings of fact: (1) upon acquiring control of Technicolor, MAF began to dismember what it viewed as Technicolor's badly conceived Kamerman Plan; (2) immediately after acquiring control, MAF started looking for buyers for Technicolor's ill-conceived businesses; and (3) a target date of June 30, 1983 was set for the liquidation of all of Technicolor's excess assets and as of December 31, 1982, MAF projected that $54 million would be realized from the sale.[39] This was known as the "Perelman Plan."[40]

The petitioners, Cede & Co. and Cinerama (Cinerama), argued that the court of chancery should value Technicolor as it existed on the date of the merger, giving due regard to the Perelman Plan, which had been conceived of and implemented prior to the merger.[41] Technicolor argued

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[33] *Id.* at 292.
[34] *Id.*
[35] *Cede & Co.*, 684 A.2d at 292-93.
[36] *Id.*
[37] *Id.* at 293.
[38] *Id.*
[39] *Cede & Co.*, 684 A.2d at 293.
[40] *Id.*
[41] *Id.*

that it should not be valued in consideration of the Perelman Plan, but only as it existed under the Kamerman Plan.[42] The disagreement between the parties over consideration of the Perelman Plan versus the Kamerman Plan obviously resulted in different factual assumptions by their respective experts.[43] Consequently, Cinerama's expert opined that the fair value of Technicolor on a per share basis as of January 24, 1983 was $62.75, whereas Technicolor's expert opined that the fair value of Technicolor at the time of the merger was $13.14 per share.[44]

Technicolor's argument was purely a legal one: in accordance with the appraisal statute, any value attributable to the Perelman Plan as of the merger date had to be excluded as arising from the expectation of the merger, and thus, the net cash flows which followed from the Perelman Plan should be excluded from Technicolor's valuation as a matter of law.[45] Cinerama relied upon *Weinberger* and argued that the appraisal statute only mandates the exclusion of speculative elements of value arising from the accomplishment or expectation of the merger, but that elements of future value which are known or susceptible to proof as of the date of the merger may be considered even if it is an element of value arising from the merger.[46]

The court of chancery agreed with Technicolor. On appeal, the Delaware Supreme Court described the court of chancery's reasoning as follows:

> The Court of Chancery acknowledged that, based upon the quoted language from *Weinberger*, Cinerama's legal argument appeared to be persuasive. The Court of Chancery concluded, however, "that reading [of *Weinberger*] is too difficult to square with the plain words of the statute

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[42]*Id.* at 293-94. Technicolor argued to the court of chancery that the Perelman Plan was not sufficiently defined on the date of the merger to form the factual premise for the Cinerama expert's cash flow projections from asset sales. *Id.* at 295.

> The Court of Chancery [rejected that assertion and] made a specific factual finding that "the record supports the conclusion that MAF intended from the outset to realize by one technique or another the capital value of One Hour Photo and to terminate that division's drain on the company's cash flow. Insofar as sale of that enterprise is involved, the 'Perelman Plan' was fixed by the merger date."

Id. (quoting Cede & Co. v. Technicolor, Inc., No. 7129, 1990 Del. Ch. LEXIS 259, at *62 (Del. Ch. July 12, 1990))(citations omitted).

[43]*Cede & Co.*, 684 A.2d at 294.

[44]*Id.* at 294 n.3.

[45]*Id.* at 295.

[46]*Id.*

to permit the conclusion that that is what was intended." The Court of Chancery then stated "in order to understand the quoted passage [from *Weinberger*] when read together with the statutory language, I assume an unexpressed phrase to the effect 'unless, but for the merger, such elements of future value would not exist.'" According to the Court of Chancery, the language in *Weinberger* would read: "But elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered [unless, but for the merger, such elements of future value would not exist]."

. . . .

Accordingly, the Court of Chancery concluded that "[f]uture value that would not exist *but for* the merger . . . even if it is capable of being proven on the date of the merger," is irrelevant in a Delaware statutory appraisal proceeding. Consequently, the Court of Chancery held "that value added to [Technicolor] by the implementation or the expectation of the implementation of Mr. Perelman's new business plan for [Technicolor] is not value to which, in an appraisal action, [Cinerama] is entitled to a *pro rata* share, but is value that is excluded from consideration by the statutory exclusion for value arising from the merger or its expectation."[47]

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[47]*Cede & Co.*, 684 A.2d at 295-96 (quoting *Weinberger*, 457 A.2d at 713; *Cede & Co.*, 1990 Del. Ch. LEXIS 259, at *65-66) (emphasis added). The Delaware Supreme Court also acknowledged that many legal scholars have written on elements of value to be considered in an appraisal proceeding, particularly with regard to cash-out two-step mergers. *E.g.*, John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359 (1996); Benjamin Hermalin & Alan Schwartz, *Buyouts in Large Companies*, 25 J. LEGAL STUD. 351 (1996); Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235 (1990); Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1 (1995); *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991) (discussing appraisal and valuation in mergers); Bate C. Toms, III, *Compensating Shareholders Frozen Out in Two-Step Mergers*, 78 COLUM. L. REV. 548 (1978) (discussing elements of value to be considered in appraisal proceeding); Angie Woo, Note, *Appraisal Rights in Mergers of Publicly-Held Delaware Corporations: Something Old, Something New, Something Borrowed, and Something B.L.U.E*, 68 S. CAL. L. REV. 719 (1995) (discussing valuation in cash-out two-

The court noted further that:

> [t]he Court of Chancery reasoned that valuing Technicolor as a going concern, under the Perelman Plan, on the date of the merger, would be tantamount to awarding Cinerama a proportionate share of a control premium, which the Court of Chancery deemed to be both economically undesirable and contrary to this Court's holding in *Bell v. Kirby Lumber Corp.* . . . . Thus, the Court of Chancery concluded "that value [added by a majority acquiror] is not . . . a part of the 'going concern' in which a dissenting shareholder has a legal (or equitable) right to participate."[48]

The Delaware Supreme Court reversed the court of chancery, holding that in a two-step merger, to the extent that value has been added following a change in control before the minority is cashed-out, it is still value attributable to the going concern on the date of the merger.[49] As a consequence, the court further held that value added to the going concern by the majority acquiror during the transient period of a two-step merger accrues to the benefit of all stockholders and must therefore be included in the appraised value.[50] In dealing with the facts before it, the court then concluded that "[b]y failing to accord Cinerama the *full proportionate value of its shares in the going concern on the date of the merger*, the court of chancery imposed a penalty upon Cinerama for lack of control."[51] The court remanded the case with the following instruction:

> Following this remand, Technicolor must be viewed and valued "as an-ongoing enterprise, occupying a particular market position in the light of future prospects." All "elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may [and should] be considered."[52]

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step transactions).

[48]*Cede & Co.*, 684 A.2d at 298 (quoting *Cede & Co.*, 1990 Del. Ch. LEXIS 259, at *71) (footnote and citation omitted).

[49]*Id.* (citing *Rapid-American Corp.*, 603 A.2d at 805).

[50]*Id.* at 298-99 (citations omitted).

[51]*Id.* at 299 (citing *Cavalier Oil*, 564 A.2d at 1145). *Accord* Rapid-American Corp., 603 A.2d at 805-07; *Bell*, 413 A.2d at 140-42.

[52]*Cede & Co.*, 684 A.2d at 300 (quoting *Shell Oil*, 607 A.2d at 1218-19; *Weinberger*, 457 A.2d at 713, respectively).

In *Cede & Co.*, the Delaware Supreme Court also issued the following guideline for future appraisal proceedings:

> The "accomplishment or expectation" of the merger exception in Section 262 is very narrow, "designed to eliminate use of *pro forma* date and projections of a speculative variety relating to the completion of a merger." That narrow exclusion does not encompass known elements of value, including those which exist on the date of the merger because of a majority acquiror's interim action in a two-step cash-out transaction. "[O]nly the *speculative* elements of value that may arise from the 'accomplishment or expectation' of the merger" should have been excluded from the Court of Chancery's calculation of fair value on the date of the merger.[53]

This guideline and the instructions on remand *may* finally bring to a close an appraisal action that was filed more than fourteen years ago.[54]

As pointed out in the analysis in *Cede & Co.*, neither control premiums nor minority discounts (reflecting a less than fifty percent holding or a stock's nonmarketability), may be considered when determining the value of a particular stockholder's interest in the corporation in appraisal actions.[55] In *Cavalier Oil Corp. v. Harnett*,[56] the

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[53]*Id.* at 299 (quoting *Weinberger*, 457 A.2d at 713) (alteration in original).

[54]The history of the *Cede & Co.* case has been discussed at length in several opinions. *See, e.g.*, *Cinerama*, 663 A.2d at 1135-37; Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 351-58 (Del. 1993) (*Technicolor II*); *Technicolor I*, 542 A.2d at 1185-86.

[55]*See Rapid-American Corp.*, 603 A.2d at 805 (stating that the number of shares owned by stockholders is not considered in the valuation process by way of discounting or adjusting the control premium at the stockholder level); *Cavalier Oil Corp.*, 564 A.2d at 1145 (stating no discount should be applied to minority shareholders due to lack of marketability); Salomon Bros. Inc. v. Interstate Bakeries Corp., No. 10,054, Del. Ch. 1992 LEXIS 100, at *12 (Del. Ch. May 1, 1992), *reprinted in* 18 DEL. J. CORP. L. 756, 760 (1993); *see also Technicolor I*, 542 A.2d at 1187 ("the only relief available [in an appraisal action] is a judgment against the surviving corporation for the fair value of the dissenter's shares"); Charlip v. Lear Siegler, No. 5178, 1984 WL 8248 (Del. Ch. Nov. 27, 1984), *reprinted in* 10 DEL. J. CORP. L. 168 (1985) (refusing to apply 50% discount to stock because no active trading market existed for stock).

Some states permit consideration of minority and nonmarketability discounts. *See, e.g.*, Hernando Bank v. Huff, 609 F. Supp. 1124, 1126 (N.D. Miss. 1985) (applying minority discount for lack of control under Mississippi law), *aff'd*, 796 F.2d 803 (5th Cir. 1986); Perlman v. Permonite Mfg. Co., 568 F. Supp. 222, 231-32 (N.D. Ind. 1983) (applying both minority and nonmarketability discounts under Indiana corporate law), *aff'd*, 734 F.2d 1283 (7th Cir. 1984); Moore v. New Ammest, Inc., 630 P.2d 167, 177 (Kan. Ct. App. 1981) (applying 20% minority discount under Kansas law); Columbia Management Co. v. Wyss, 765

Delaware Supreme Court explained the basis for excluding discounts from consideration:

> Cavalier's argument, that the only way Harnett would have received value for his 1.5% stock interest was to sell his stock, subject to market treatment of its minority status, misperceives the nature of the appraisal remedy. Where there is no objective market data available, the appraisal process is not intended to reconstruct a *pro forma* sale but to assume that the shareholder was willing to maintain his investment position, however slight, had the merger not occurred. Discounting individual share holdings injects into the appraisal process speculation on the various factors which may dictate the marketability of minority shareholdings. More important, to fail to accord to a minority shareholder the full proportionate value of his shares imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may reap a windfall from the appraisal process by chasing out a dissenting shareholder, a clearly undesirable result.[57]

In comparison, however, application of discounts or premiums at the stockholder level can be distinguished from their application at the company level.[58] For example, where the company being valued has a majority ownership interest in certain subsidiaries, that "control premium" may be factored into a determination of the company's value during appraisal, but the individual stockholder's proportionate share of the company being valued must then be calculated on a pure pro rata basis, without regard for the size of his or her holdings.[59] In *Rapid-American Corp. v. Harris*,[60] the Delaware Supreme Court held that a control premium at the parent level should be included in an appraisal valuation to compensate the parent's stockholders for the parent's 100% interest in three subsidiaries. The court noted that the parent's 100% ownership

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P.2d 207, 213 (Or. Ct. App. 1988) (applying 33% discount for nonmarketability of dissenter's shares under Oregon law).

[56]564 A.2d 1137 (Del. 1989).

[57]*Id.* at 1145.

[58]*Rapid-American Corp.*, 603 A.2d at 805-06; *Cavalier Oil*, 564 A.2d at 1144-45; *see also Tri-Continental*, 74 A.2d at 76 (discussing discounting of corporation's asset value to reflect going-concern of close-ended investment company).

[59]*Rapid-American Corp.*, 603 A.2d at 805-07.

[60]603 A.2d 796 (Del. 1992).

interest "was clearly a 'relevant' valuation factor and the trial court's rejection of the 'control premium' implicitly placed a disproportionate emphasis on pure market value."[61] Thus, the court remanded the case for consideration of the value added to the stock by the "control premium."[62]

As discussed, an appraisal proceeding is separate and distinct from a breach of fiduciary duty action and, under ordinary circumstances, claims made in the latter generally have little bearing on the calculation of fair value. However, if corporate fiduciaries engage in self-dealing and construct a merger transaction such that it will not produce a fair price for the stockholders, those types of facts may be considered by the court when assessing the credibility of the valuation presented by the respondent corporation.[63]

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[61] *Id.* at 806-07.

[62] *Id.* at 807; *see also* Harris v. Rapid-American Corp., No. 6462, 1992 Del. Ch. LEXIS 75, at *13 (Del. Ch. Apr. 1, 1992), *reprinted in* 18 DEL. J. CORP. L. 307, 315 (1993) (adding a control premium at the company level on remand). Additionally, a "key man" discount may also be considered. *See* Hodas v. Spectrum Tech. Inc., No. 11,265, 1992 Del. Ch. LEXIS 252, at *13 (Del. Ch. Dec. 7, 1992), *reprinted in* 18 DEL. J. CORP. L. 1017, 1024 (1993) (finding evidence supported expert's conclusion that founder of corporation was so crucial to operation that departure would mean corporation's demise).

Substantial debt may also be a consideration in determining appraisal value. In *In re* Vision Hardware Groups, Inc., 669 A.2d 671 (Del. Ch. 1995), *aff'd without op. sub nom.* Young v. Vision Hardware Group, 676 A.2d 909 (Del. 1996), the court stated:

> [W]here the company is not financially able to refinance its debt (and thus itself realize some value from the spread between the market value of its debt and the face amount of the legal liability), is insolvent and on the verge of bankruptcy, the appraisal value of its stock, insofar as affected by its debts, is determined by reference to the amount of its legal liability to pay its debt.

Id. at 672. The court also stated: "Indeed when the corporation is not heading imminently for bankruptcy, I suppose that more typically the better valuation technique will be to value corporate debt at its market value if that can be established." *Id.* at 678-79. Similarly, in *Rapid-American Corp.*, the court commented as follows: "The face value of Rapid's debt at the time of the merger was $652,589,000, while the contemporaneous market value of the same debt was $356,154,000. The court was free to consider the realities of the market place in its evaluation of Rapid's intrinsic value." *Rapid-American Corp.*, 603 A.2d at 804.

[63] Pinson v. Campbell-Taggart, Inc., No. 7499, 1989 Del. Ch. LEXIS 50, at *20 (Del. Ch. Feb. 28, 1989) (revised Apr. 21, 1989 & Aug. 11, 1989), *reprinted in* 14 DEL. J. CORP. L. 1095, 1108 (1989). *See also* Alabama By-Products Corp. v. Neal, 588 A.2d 255, 258 (Del. 1991) (stating courts may consider the respondents' conduct at the time of the merger in assessing the credibility of the respondents' testimony); *In re* Radiology Assocs., Inc. Litig., 611 A.2d 485, 498 (Del. Ch. 1991) (finding that defendants' breach of fiduciary duty undermined credibility of information supplied and credibility of valuation approach); *In re* Chang's Holdings v. Universal Chems. & Coatings, No. 10,856, 1992 WL 301327, at *1 (Del. Ch. Oct. 13, 1992) (evidence of breach of fiduciary duty is relevant due to possible affect on type and amount of information supplied to experts for valuation).

Value was traditionally arrived at in appraisal proceedings by determining "the true or intrinsic value" of the stockholders' proportionate interest in the company, valued on a "going concern" rather than a liquidated basis.[64] In *Weinberger*,[65] the Delaware Supreme Court broadened or liberalized the process for determining the "fair value" of a company's outstanding shares to include all generally accepted techniques of valuation in the financial community and thereby supplemented previously rigid approaches to valuation.[66] After *Weinberger*, a plethora of methodologies may be employed and no one method is dispositive.[67] The most commonly employed valuation

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[64]*Cede & Co.*, 684 A.2d at 298; *Technicolor I*, 542 A.2d at 1186.

[65]457 A.2d 701 (Del. 1983).

[66]*Technicolor I*, 542 A.2d at 1186-87. The court also has the discretionary power to award interest in an appraisal proceeding. DEL. CODE ANN. tit. 8, § 262(k) (1991). Section 262(k) provides that "no appraisal proceeding . . . shall be dismissed as to any stockholder without the approval of the Court, and such approval may be conditioned upon such terms as the Court deems just." This provision does not give the court of chancery authority to reform a settlement agreement that was premised upon a unilateral mistake. *In re* Enstar Corp., 604 A.2d 404, 414 (Del. 1992).

[67]In an appraisal proceeding, the burden of proof is placed equally on the parties who must prove their respective valuations by a preponderance of the evidence. *See Pinson*, 1989 Del. Ch. LEXIS 50, at *19, *reprinted in* 14 DEL. J. CORP. L. at 1108 ("[N]o presumptions, favorable or unfavorable, attach to either side's valuation . . . .").

Traditionally, appraisal proceedings have involved a battle of the parties' experts. Kahn v. Household Acquisition Corp., 591 A.2d 166, 175 (Del. 1991) ("As is often the case in disputed appraisal proceedings, the dispute over [value] . . . [becomes] a battle of experts, each espousing a particular technique which purport[s] to demonstrate the fairness of their respective positions."); *Shell Oil*, 607 A.2d at 1222 (recognizing "the clash of contrary, and often antagonistic, expert opinions on value"). These battles have resulted in large and complex hearings before Delaware's Court of Chancery. *See* Edward P. Welch & Andrew J. Turezyn, *Courts Rethink Approaches to Appraisal*, NAT'L L.J., Feb. 3, 1992, at 25 (discussing the changes in the appraisal remedy subsequent to *Weinberger*). Not surprisingly, the experts often have drastically different opinions on the issue of "fair value." *See, e.g.*, Harris v. Rapid-American Corp., No. 6462, 1990 Del. Ch. LEXIS 166, at *2 (Del. Ch. Oct. 2, 1990), *reprinted in* 16 DEL. J. CORP. L. 1478, 1482 (1991) (petitioner's value was $79.00 per share versus respondent's value of $28.00 per share); *In re* Shell Oil Corp., No. 8080, 1990 Del. Ch. LEXIS 199, at *1-2 (Del. Ch. Dec. 11, 1990) (petitioner's value was $89.00 per share versus respondent's value of $55.00 per share); *Radiology Assocs.*, 611 A.2d at 489 (petitioner's value was $2,300.00 per share versus respondent's value of $457.00 per share); Cede & Co. v. Technicolor Inc., No. 7129, 1990 Del. Ch. LEXIS 259, at *4-5 (Del. Ch. Oct. 19, 1990) (petitioner's value was $62.75 per share versus respondent's value of $13.14 per share). This disparity has led to comments from the court of chancery such as "[a] review of this testimony clearly shows the reason that testimony as to value by experts is of such limited use to a trier of fact." *Shell Oil*, 1990 Del. Ch. LEXIS 199, at *14, 213. To remedy this problem, the Delaware courts are authorized to appoint a single appraiser to determine the value of a corporation's stock and the Delaware Supreme Court has strongly recommended the appointment of such experts. *See Shell Oil*, 607 A.2d at 1223 ("[W]e believe the time has

methodologies are discussed in some detail in Part II of this article.

B. *Breach of Fiduciary Duty Claims*

1. Delaware Law

Under Delaware law, the responsibility for managing a corporation's business and affairs falls upon its board of directors.[68] In discharging this responsibility, the directors have fiduciary duties, which include the duty of care, the duty of loyalty, and the duty of full disclosure to the corporation and its stockholders.[69]

The fiduciary duty of care requires a board of directors to not delegate duties that are "at the heart" of managing the company, and that the board exercise due care in overseeing the actions of those to whom it does delegate duties.[70] The duty of care also requires that, prior to making business decisions, directors must inform themselves of all material information including alternatives to the proposed course of

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come for the Court of Chancery to avail itself of [the use of a court appointed expert] whenever it believes that a more objective presentation of evidence is required, particularly in valuation matters."). In Kleinwort Benson Ltd. v. Silgan Corp., No. 11,107, 1995 Del. Ch. LEXIS 75 (Del. Ch. June 15, 1995), *reprinted in* 20 DEL. J. CORP. L. 1079 (1995), the court of chancery appointed a neutral expert to critique the parties' experts. *Compare* Cede & Co. v. Technicolor, Inc., No. 7129, 1990 Del. Ch. LEXIS 259 (Del. Ch. Oct. 19, 1990) (in suit seeking judicial appraisal of share value, court critically analyzed valuation models produced by parties, then used experts' models to come to its own conclusion regarding value of stock). In scrutinizing expert testimony, the court will exercise extreme caution and will take into consideration any factors that weigh on credibility. *See, e.g.*, *In re* Shell Oil Corp., No. 8080, 1990 Del. Ch. LEXIS 199 (Del. Ch. Dec. 11, 1990), *aff'd*, 607 A.2d 1213 (Del. 1992) (taking into consideration existence of obvious conflict of interest where fairness opinion was produced by investment banker whose fee was contingent on offer's success).

[68]DEL. CODE ANN. tit. 8, § 141(a) (1991). In Aronson v. Lewis, 473 A.2d 805 (Del. 1984), the court identified § 141(a) as a "cardinal precept" of Delaware General Corporation Law. *Id.* at 811. Specifically, § 141(a) states:

> The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such an extent and by such person or persons as shall be provided in the certificate of incorporation.

[69]Similar duties apply to "officers" of Delaware corporations. *See* Lynch v. Vickers Energy Corp., 429 A.2d 497, 502-03 (Del. 1981) ("[A] fiduciary relationship [arises] from the directors and *officers* to their corporation . . . .") (emphasis added).

[70]*See* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); Canal Capital Corp. v. French, No. 11,764, 1992 Del. Ch. LEXIS 133, at *5-6 (Del. Ch. July 2, 1992), *reprinted in* 18 DEL. J. CORP. L. 611, 614 (1993).

action, and must make "reasonable inquiry" as to the merits of the proposed course of action.[71]

The fiduciary duty of loyalty forbids corporate fiduciaries, including directors, officers, and controlling stockholders,[72] from considering or acting to protect interests other than those of the corporation when making business decisions.[73] For example, a fiduciary cannot use his or her position in the corporation to promote a transaction between the corporation and an entity in which he or she has a substantial economic interest, unless that transaction is substantively fair to the corporation.[74] Issues regarding the duty of loyalty arise in many contexts, such as direct dealings (e.g., purchases or sales) between the corporation and the fiduciary, dealings between a parent corporation and a subsidiary, unfair conduct by a majority stockholder in corporate reorganizations or

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[71]Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985); *Aronson*, 473 A.2d at 812; *see also* UIS, Inc. v. Walbro Corp., No. 9323, 1987 WL 18108, at *2 (Del. Ch. Oct. 6, 1987), *reprinted in* 13 DEL. J. CORP. L. 806, 810 (1988) (stating directors have a duty to act on an informed basis). The duty of care may be heightened in situations involving potential changes in corporate control — such as mergers or tender offers — and in situations where the board undertakes defensive measures in response to a threatened change of control. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

[72]In certain circumstances, a controlling stockholder owes a fiduciary duty to the minority stockholders. *See, e.g.*, Harriman v. E.I. duPont de Nemours & Co., 372 F. Supp. 101 (D. Del. 1974). In *Harriman*, the court stated that "a stockholder who in fact controls the management of a Delaware corporation owes a fiduciary duty to the corporation and its shareholders." *Id.* at 105. Mere ownership of stock does not appear to be enough to impose such a fiduciary duty. Some affirmative acts must be alleged as the *Harriman* Court went on to hold that "it is only when a person affirmatively undertakes to dictate the destiny of the corporation that he assumes such a fiduciary duty." *Id.* at 106. Dictating the destiny of the corporation can be achieved by intruding into the affairs of the board of directors or by exercising stockholder power as a majority stockholder. *Id. See also* Harris v. Carter, 582 A.2d 222, 234 (Del. Ch. 1990) (noting that when a stockholder presumes to exercise control over the corporation, to direct its actions, that stockholder assumes the same type of fiduciary duty as that owed by a director to the corporation); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) ("Under Delaware law a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation."). *But see* Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 845 (Del. 1987) ("[A] stockholder is under no duty to sell its holdings in a corporation, even if it is a majority shareholder, merely because the sale would profit the minority."); *Harris*, 582 A.2d at 234 (noting that "a shareholder has a right to sell his or her stock and in the ordinary case owes no duty in that connection to other shareholders when acting in good faith") (citing Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 408 (Del. 1985)).

[73]Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986); *Weinberger*, 457 A.2d at 710; Guth v. Loft, 5 A.2d 503, 510 (Del. 1939).

[74]Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) (stating directors must demonstrate both good faith and fairness in a transaction in which they possess a financial interest).

acquisitions, actions taken by fiduciaries for the purpose of entrenching themselves in office, insider trading, sales of control, usurpation of corporate opportunities,[75] and conduct by fiduciaries in competition with the corporation.

The fiduciary duty of full disclosure mandates that corporate fiduciaries fully and fairly disclose to stockholders all material information[76] within their control whenever they seek some type of stockholder action (e.g., board solicitation of proxies[77] or advice on right

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[75]Under Delaware law, a corporate officer or director may not benefit personally from a business opportunity if: (1) the opportunity is within the corporation's line of business, (2) the corporation has an interest or expectancy in the opportunity, (3) the corporation is financially able to take advantage of the opportunity, and (4) the corporate fiduciary would be placed in a position inimicable to his or her fiduciary duties by accepting the business opportunity. Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 154-55 (Del. 1996). A corporate fiduciary may, however, take such an opportunity for his/her own if: (1) the opportunity was presented to him or her in his or her individual, as opposed to corporate, capacity; (2) the opportunity is not essential to the corporation; (3) the corporation has no interest or expectancy in the opportunity; and (4) the fiduciary has not wrongfully used corporate resources in taking advantage of the opportunity. *Id.* at 155.

[76]The standard for "materiality" under Delaware law for purposes of the duty of disclosure regarding proxy materials is the same as that applied under the federal securities laws: information will be considered "material" if a reasonable stockholder would consider it important in deciding what course of conduct to choose. *See Bershad*, 535 A.2d at 846; Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944-45 (Del. 1985) (a fact is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available") (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)); Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. 1977) (noting that "information such as a reasonable shareholder would consider important in deciding whether to sell or retain stock" should be disclosed).

There is no duty to disclose information that is common knowledge, Fisher v. United Technologies Corp., No. CIV.A.5847, 1981 WL 7615, at *3 (Del. Ch. May 12, 1981), *reprinted in* 6 DEL. J. CORP. L. 380, 385 (1981), or that which constitutes mere speculation. Tuckman v. Aerosonic Corp., No. 4094, 1982 WL 17810, at *10-11 (Del. Ch. May 20, 1982). Nor are corporate officers or directors required to engage in self-flagellation by confessing wrongdoing before it is determined by a court of law. Loudon v. Archer-Daniels-Midland Co., No. 14,638, 1996 Del. Ch. LEXIS 12, at *12 (Del. Ch. Feb. 20, 1996), *reprinted in* 21 DEL. J. CORP. L. 724, 732 (1996). Fiduciaries are also not obligated to disclose preliminary merger negotiations as disclosure of such negotiations is required only if the negotiations have gone beyond the preliminary stages and a price and structure for the merger have been agreed upon. *Bershad*, 535 A.2d at 847.

[77]*See, e.g.*, *Loudon*, 1996 Del. Ch. LEXIS 12, at *12-14, *reprinted in* 21 DEL. J. CORP. L. at 732. The standard applicable to disclosures in the context of going-private or freeze-out transactions is even higher than that applied in connection with proxy statements. Smith v. Shell Petroleum, Inc., No. 8395, 1990 Del. Ch. LEXIS 82, at *36 (Del. Ch. June 19, 1990), *reprinted in* 16 DEL. J. CORP. L. 870, 891 (1991), *aff'd*, 606 A.2d 112 (Del. 1992); Glassman v. Wometco Cable TV, Inc., No. 7307, 1989 Del. Ch. LEXIS 1, at *6 (Del. Ch. Jan. 6, 1989). This is because, in such situations, the majority has the power to leave the minority

to appraisal).[78]

Stockholders of Delaware corporations who believe that fiduciaries of those corporations have violated their duties of care, loyalty, and/or disclosure may bring causes of action alleging breach of fiduciary duty against such persons in Delaware's Court of Chancery, a court of equity.[79] Such actions may be brought either as direct actions[80] or as

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stockholders with only the options of dissent or appraisal, options which cannot reasonably be evaluated without complete disclosure regarding the company's value. *Smith*, 1990 Del. Ch. LEXIS 82, at *36-37, *reprinted in* 16 DEL. J. CORP. L. at 891-92 (citing Radol v. Thomas, 772 F.2d 244, 255 (6th Cir. 1985), *cert. denied*, 477 U.S. 903 (1986)).

[78]*E.g.*, Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1280-81 (Del. 1994); *Lynch*, 383 A.2d at 281. In addition, at least two judges on Delaware's Court of Chancery have recognized that even if the board does not seek shareholder action, if it undertakes to voluntarily disclose information to shareholders it must do so fully, fairly, and accurately. *See* Marhart, Inc. v. Calmat Co., No. 11,820, 1992 Del. Ch. LEXIS 85, at *7-8 (Del. Ch. Apr. 22, 1992), *reprinted in* 18 DEL. J. CORP. L. 330, 335 (1993); Levy v. Stern, No. 11,955, 1996 Del. Ch. LEXIS 25, at *3-5 (Del. Ch. Mar. 12, 1996), *reprinted in* 21 DEL. J. CORP. L. 1218, 1221-23 (1996) (refusing to reconsider denial of motion to dismiss where plaintiff stockholder claimed to have suffered monetary damages as a result of making decisions based on misstatements in annual report that was not disseminated for purpose of soliciting stockholder action), *rev'd on other grounds*, No. 211, 1996 Del. LEXIS 468 (Del. Dec. 20, 1996). However, in Kahn v. Roberts, No. 12,324, 1995 Del. Ch. LEXIS 151 (Del. Ch. Dec. 6, 1995) (revised Dec. 15, 1995), *reprinted in* 21 DEL. J. CORP. L. 674 (1996), *aff'd*, 679 A.2d 460 (Del. 1996), Chancellor Allen held that misleading disclosures by directors in a company's annual report should be redressed pursuant to the federal securities laws rather than Delaware corporate law because no stockholder action was being sought. *Id.* at *20-22, *reprinted in* 21 DEL. J. CORP. L. at 689. On appeal, the Delaware Supreme Court in *Kahn* found that none of the disclosure violations were material and thus stated that "we need not and do not reach today the question of whether a duty of disclosure exists absent shareholder action." *Kahn*, 679 A.2d at 467. However, the Court did state that "[n]otably, this Court has never stated that full disclosure is required *only when* seeking shareholder action." *Id.* Since *Kahn*, Chancellor Allen has opined that "the better view and that accepted by a majority of the judges who have expressed an opinion, is that fiduciary liability for misdisclosures requires that the material misstatement or omission by a fiduciary be in connection with the solicitation of shareholder action, such as a tender, a vote, a consent or a withholding of the same." Uni-Marts, Inc. v. Stein, Nos. 14,713 & 14,893, 1996 Del. Ch. LEXIS 95, at *21 (Del. Ch. Aug. 9, 1996). "A respect for the evolved roles of state regulation of internal corporate affairs and federal regulation of securities markets counsels against" the "radical result" of finding breaches of the fiduciary duty of disclosure where no stockholder action is sought. *Id.* at *22.

[79]Breach of fiduciary duty claims are particularly valuable tools for stockholders seeking to bring class action claims against a corporate defendant. The Delaware courts specifically permit certification of nationwide stockholder classes in breach of fiduciary duty cases. *See generally In re* Tri-Star Pictures, Inc. Litig., 634 A.2d 319 (Del. 1993) (involving class action claim for breach of the fiduciary duty of disclosure); *but see* Gaffin v. Teledyne, Inc., 611 A.2d 467, 474 (Del. 1992) ("A class action may not be maintained in a purely common law or equitable fraud case since individual questions of law or fact, particularly as to the element of justifiable reliance, will inevitably predominate over common questions of law or fact.") (footnote omitted). Moreover, because a majority of large corporations are

incorporated in Delaware, the corporate law of that state is by far our nation's most developed and influential. Delaware's Court of Chancery, one of the country's most respected courts, has jurisdiction over all of the breach of fiduciary claims discussed herein. *See* William H. Rehnquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice*, 48 BUS. LAW. 351 (1992) (providing general discussion of the national prominence of Delaware's Court of Chancery). While it is not necessary for corporate claims brought pursuant to Delaware law to be filed in Delaware, the majority of such claims are brought in Delaware's state courts for several reasons. First, the Delaware judiciary, with its vast experience in dealing with complex corporate matters, is better suited than the judiciary of any other state to decide questions relating to corporate governance. Second, the court of chancery and Supreme Court of Delaware are well known for their ability to manage cases efficiently, and to provide expedited resolution of time-sensitive matters. Perhaps most important, however, is the fact that the Delaware courts have personal jurisdiction over the directors of all Delaware corporations in actions brought against them under Delaware law in their capacities as directors. DEL. CODE ANN. tit. 10, § 3114 (Supp. 1996); *In re* USA Cafes, L.P. Litig., 600 A.2d 43, 52-53 (Del. Ch. 1991); Hana Ranch, Inc. v. Lent, 424 A.2d 28, 30 (Del. Ch. 1980). Notably, the personal jurisdiction conferred by § 3114 does not extend to individuals who are officers, but not directors, of Delaware corporations. *See* Sternberg v. O'Neil, 550 A.2d 1105, 1126-27 (Del. 1988) (affirming dismissal of complaint due to lack of personal jurisdiction over nonresidents who were officers but not directors of the Delaware corporation at issue). By filing suit in Delaware, a plaintiff stockholder need not be concerned about whether the State in which it is filing suit has the requisite contacts with each of the intended defendants to render those defendants amenable to the jurisdiction of that state's courts. This is often not the case when filing suit in other jurisdictions. *See, e.g.*, Alpert v. Bertsch, 601 N.E.2d 1031, 1037 (Ill. App. Ct. 1992) (dismissing claims against directors, including claim for breach of fiduciary duty, due to lack of personal jurisdiction over nonresident directors whose only contact with State of Illinois was in their capacity as corporate fiduciaries).

[20]Direct actions are appropriate where the individual stockholder plaintiff has suffered some special injury not generally shared by the stockholders. For example, board actions that interfere with a stockholder's contractual or voting rights may properly be the subject of direct actions for breach of fiduciary duty. *See Tri-Star Pictures*, 634 A.2d at 330; *Technicolor I*, 542 A.2d at 1188; Lipton v. News Int'l, Plc, 514 A.2d 1075, 1078-79 (Del. 1986); Moran v. Household Int'l, Inc., 490 A.2d 1059, 1069-70 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985). In *Lipton*, for example, the court found that a stockholder of Warner Communications, Inc. had stated a viable direct claim against Warner and its directors where it was alleged that the Warner board had entered into an exchange agreement that secured veto power for Warner management over stockholder votes. *Lipton*, 514 A.2d at 1078-79. Because this exchange agreement violated the plaintiff's contractual voting rights — rights that were independent of any rights of Warner as a corporate entity — the plaintiff's claim was held to be direct in nature rather than derivative. *Id.* at 1079. Likewise, in *Tri-Star Pictures*, the minority stockholders alleged that they had suffered direct harm as the result of a transaction in which the controlling stockholder obtained newly issued shares from the corporation in exchange for property whose value had been fraudulently inflated, diluting the value of the minority stockholders' shares and diluting their voting power as well. *Tri-Star Pictures*, 634 A.2d at 326-27, 330-33. The Delaware Supreme Court held that because the minority stockholders had suffered harm that had not been suffered by all stockholders equally (i.e., harm that had not been suffered by the majority stockholder), the minority stockholders' claims were direct rather than derivative. *Id.* at 330-32; *see also* Katz v. Halperin, No. 13,811, 1996 Del. Ch. LEXIS 13, at *14 (Del. Ch. Feb. 5, 1996) (revised Feb. 8, 1996), *reprinted in* 21 DEL. J. CORP. L. 690,

derivative suits.[81] If an action is brought derivatively, there are certain factual[82] and procedural prerequisites that will have to be met, including

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699 (1996) ("According to Delaware law, a claim of mismanagement resulting in corporate waste is derivative in nature, not individual.") (citations omitted). Claims by stockholders seeking damages as a result of being deprived of the right to cast a fully informed vote are also properly brought as direct claims. *See, e.g.*, Thorpe v. CERBCO, Inc., No. 11,713, 1993 Del. Ch. LEXIS 16, at *5-7 (Del. Ch. Jan. 26, 1993), *reprinted in* 18 DEL. J. CORP. L. 1196, 1200 (1993) (holding that breach of fiduciary claims based upon inadequate proxy disclosure are direct rather than derivative), *aff'd in part, rev'd in part*, 676 A.2d 436 (Del. 1996); *see also* Weinberger v. UOP, Inc., No. CIV.A.5642, 1985 WL 11546 (Del. Ch. Jan. 30, 1985), *reprinted in* 10 DEL. J. CORP. L. 945 (1985) (awarding damages to plaintiffs in class action suit involving majority stockholder's withholding of material information so as to deprive the minority of a fair opportunity to cast fully informed votes to approve or reject a proposed merger).

[81]Derivative actions are appropriate when the injury in question is to the corporation as a whole, as is typically the case with respect to allegations of mismanagement or corporate waste. *See* Shapiro v. Pabst Brewing Co., No. 7339, 1985 WL 11578, at *4 (Del. Ch. July 30, 1985), *reprinted in* 11 DEL. J. CORP. L. 704, 709 (1986) ("To the extent that the complaint purports to state an entrenchment or a waste of corporate assets breach of fiduciary duty claim . . . those wrongs are derivative claims which may not be pursued either individually or as a class action."). For example, in Kramer v. Western Pac. Indus., Inc., 546 A.2d 348 (Del. 1988), the plaintiff alleged that the board of directors had engaged in a series of wasteful transactions — such as payment of unnecessary options, bonuses, and fees — that resulted in an illegal diversion of funds from the stockholders. *Id.* at 349. The Delaware Supreme Court held that the gravamen of the plaintiff's complaint was mismanagement resulting in waste of corporate assets, and that "Delaware courts have long recognized that actions charging 'mismanagement which depress[] the value of [the] stock [allege] a wrong to the corporation; i.e., the stockholders collectively, to be enforced by a derivative action.'" *Id.* at 353 (quoting Bokat v. Getty Oil Co., 262 A.2d 246, 249 (Del. 1970)). The court explained the basis for this rule as follows:

> A claim of mismanagement resulting in corporate waste, if proven, represents a direct wrong to the corporation that is indirectly experienced by all shareholders. Any devaluation of stock is shared collectively by all the shareholders, rather than independently by the plaintiff or any other individual shareholder. Thus, the wrong alleged is entirely derivative in nature.

Id. Recovery in a successful derivative action goes to the corporation itself, and the stockholder benefits indirectly in accordance with his or her proportional interest in the corporation. *But see* Lynch v. Patterson, 701 P.2d 1126, 1130-31 (Wyo. 1985) (When stockholder's claim was based on excessive salaries and fees, the court stated, "Direct recovery assures that Patterson will reap some benefit from his lawsuit. We refuse to order payment into the corporate treasury in this case and risk necessitating a subsequent suit by Patterson to compel the directors to declare a dividend or apply the funds to legitimate corporate purposes.").

[82]Derivative actions are governed by § 327 and Chancery Court Rule 23.1, which require that a stockholder meet several requirements in order to become a stockholder derivative plaintiff. First, he or she must have been a stockholder at the time of the alleged wrongdoing, or the stock must thereafter have devolved upon him or her by operation of law. DEL. CODE ANN. tit. 8, § 327 (1991); DEL. CH. CT. R. 23.1. Second, a derivative plaintiff must continue to be a stockholder throughout the entire course of the litigation. *See In re* Resorts Int'l Shareholders Litig., Nos. 9470 & 9605, 1988 Del. Ch. LEXIS 130, at *33 (Del. Ch.

either making a demand upon the corporation to bring the suit in its own name, or alleging that such demand would be futile.[83] If demand is made upon the corporation and refused, the corporation's refusal will be respected by the courts unless the refusal itself was "wrongful."[84] A stockholder who elects to bypass the demand requirement because they believe it to be futile[85] must allege particular facts in his or her complaint[86] that support the existence of a reasonable doubt that: (1) a majority of the company's directors are disinterested[87] and independent,[88]

Sept. 7, 1988), *reprinted in* 14 DEL. J. CORP. L. 830, 847 (1989), *aff'd*, 570 A.2d 259 (Del. 1990); Kramer v. Western Pac. Indus., Inc., No. CIV.A.8675, 1987 WL 17043, at *2 (Del. Ch. Sept. 11, 1987), *reprinted in* 13 DEL. J. CORP. L. 723, 726 (1988), *aff'd*, 546 A.2d 348 (Del. 1988). A derivative plaintiff must also be an "adequate representative" of the corporation, qualified to serve in a fiduciary capacity as a representative of the interests of other stockholders. *See* Youngman v. Tahmoush, 457 A.2d 376, 379 (Del. Ch. 1983).

[83]*See* DEL. CH. CT. R. 23.1; Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996) ("A stockholder filing a derivative suit must allege either that the board rejected his pre-suit demand that the board assert the corporation's claim or allege with particularity why the stockholder was justified in not having made the effort to obtain board action."); Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 730 (Del. 1988) ("[S]hareholders seeking to assert a claim on behalf of the corporation must first exhaust intracorporate remedies by making a demand on the directors to obtain the action desired.").

[84]Ordinarily, the board's decision to refuse the demand will be entitled to the presumptions of the business judgment rule, discussed *infra* notes 121-22. However, if the stockholder alleges particular facts creating a reasonable doubt that the board acted independently or with due care in rejecting the demand, the stockholder may assert that the demand was wrongfully refused and continue to prosecute his or her derivative claim. *Grimes*, 673 A.2d at 1219; Levine v. Smith, 591 A.2d 194, 212 (Del. 1991).

[85]It should be noted that, once a plaintiff has made a demand upon the board of directors to take action, he or she has waived the right to later assert that demand should have been excused as being futile. *See Grimes*, 673 A.2d at 1215, 1218-19 ("the stockholder [however] does not, by making demand, waive the right to claim that demand has been wrongfully refused").

[86]Only the facts contained in the complaint or incorporated therein by reference will be considered on a motion to dismiss for failure to plead demand futility. Rothenberg v. Santa Fe Pac. Corp., No. 11,749, 1995 Del. Ch. LEXIS 117, at *8-11 (Del. Ch. Sept. 5, 1995), *reprinted in* 21 DEL. J. CORP. L. 309, 315-16 (1996).

[87]A director will be considered interested if he or she will derive a material financial benefit from a transaction in a manner not shared by the stockholders generally, or if a corporate decision will have a materially detrimental effect on the director not shared by the corporation and its other stockholders. *Katz*, 1996 Del. Ch. LEXIS 13, at *25-26, *reprinted in* 21 DEL. J. CORP. L. at 704 (citing Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993); *Aronson*, 473 A.2d at 812); *Rothenberg*, 1995 Del. Ch. LEXIS 117, at *13-14, *reprinted in* 21 DEL. J. CORP. L. at 317.

[88]A director will be considered "independent" if his or her decisions are based "'on the corporate merits of the subject before the board rather than extraneous considerations or influences.'" *Katz*, 1996 Del. Ch. LEXIS 13, at *26, *reprinted in* 21 DEL. J. CORP. L. at 704 (quoting *Aronson*, 473 A.2d at 816).

or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.[89]

Valuation issues often arise in breach of fiduciary duty cases including claims arising out of self-tender offers or mergers and acquisitions involving tender offers. These issues may arise at two stages of the litigation: (1) at the liability stage in determining the fairness of the transaction, and (2) at the damage stage in determining compensation to the aggrieved stockholders. When scrutinizing these and other corporate transactions, the courts distinguish between "disinterested" or "arm's-length" transactions and "interested" transactions.[90]

In a totally voluntary third party tender offer, courts do not impose any right of the stockholders to receive a particular price.[91] "Delaware law recognizes that, as to allegedly voluntary tender offers (in contrast to cash-out mergers), the determinative factor as to voluntariness is whether coercion is present, or whether there [were] 'materially false or misleading disclosures made to shareholders in connection with the offer.'"[92] In the absence of coercion[93] or disclosure violations,[94] the

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[89]*Grimes*, 673 A.2d at 1216; *Rales*, 634 A.2d at 933-34; *Levine*, 591 A.2d at 205; *Aronson*, 473 A.2d at 814. It is the independence of the directors upon whom the demand for suit would be made that is relevant, not the independence of the directors who engaged in the alleged misconduct that would be the subject of the suit. *Rales*, 634 A.2d at 933. Even having alleged such facts, however, the stockholder plaintiff will not necessarily be able to continue pursuing the litigation. Once the suit is filed, the corporation's board of directors may appoint a "special litigation committee" to evaluate the merits of the suit and determine whether or not it is in the corporation's best interests. *Grimes*, 673 A.2d at 1216 n.13 (citing Zapata Corp. v. Maldonado, 430 A.2d 779, 786 (Del. 1981)). After thoroughly investigating the allegations in the suit, the special litigation committee may cause the corporation to move to dismiss the suit. The court of chancery will grant such a motion if it is satisfied that: (1) the special litigation committee was independent, acted in good faith, and reached its conclusions after a reasonable investigation; and (2) in the court's own judgment, dismissal of the suit is in the corporation's best interests. *Zapata*, 430 A.2d at 788-89.

[90]An "arm's-length" transaction is one in which one corporation does not control the other, is not controlled by the other, and does not control persons or business entities which control the other. Conversely, an "interested" transaction is one in which a controlling entity stands on both sides of the transaction.

[91]Solomon v. Pathe Communications Corp., 672 A.2d 35, 39 (Del. 1996) (citing Lynch v. Vickers Energy Corp., 351 A.2d 570, 576 (Del. Ch. 1976), *rev'd on other grounds*, 383 A.2d 278 (Del. 1977); *Weinberger*, 457 A.2d at 703).

[92]*Id.* (quoting Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051, 1056 (Del. Ch. 1987) (citations omitted)).

[93]*See, e.g.*, AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 114 (Del. Ch. 1986) (self-tender by corporation timed so as to discourage free stockholder choice between corporation's offer and competing offer by "outside" bidder enjoined as actionably coercive).

[94]*See, e.g.*, Joseph v. Shell Oil Co., 482 A.2d 335, 343 (Del. Ch. 1984) (tender by parent corporation for publicly owned shares of 70%-owned subsidiary preliminarily enjoined

adequacy of the price in a voluntary tender offer cannot be an issue.[95] Thus, a party challenging a disinterested transaction (such as a voluntary third party tender offer) has a stringent burden and must prove "fraud" or "constructive fraud" when challenging the consideration offered in such a transaction.[96] In *Muschel v. Western Union Corp.*,[97] the court stated:

> Mere inadequacy of price will not reveal fraud, but rather the disparity must be so gross as to lead the Court to conclude that it was not due to an honest error of judgment, but rather to bad faith, or to reckless indifference to the rights of others interested. Wide discretion in the matter of valuation is confided to directors, and as long as they appear to act in good faith, with honest motives, and for honest ends, the exercise of their discretion will not be interfered with.[98]

Consequently, absent fraudulent conduct, in order for a stockholder's claim to be successful it must be grounded on a breach of fiduciary duty. If, however, the court determines that a tender offer is not totally voluntary, it may enjoin the transaction[99] or award damages as will be discussed below. In such cases, the court may have to value the corporation and the stock in question in order to calculate a damage award.

In *Eisenberg v. Chicago Milwaukee Corp.*,[100] a case involving a self-tender offer, Delaware's Court of Chancery explained the rationale for the stringent burden when challenging tender offers:

> By its very nature and form, a tender offer is normally regarded as a voluntary transaction. Unlike a cash-out merger where public stockholders can be involuntarily eliminated from the enterprise, in a properly conducted tender offer the stockholder-offerees may freely choose whether or not to tender. That choice will normally depend

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because offering documents failed to disclose facts tending to show unfairness of offering price and deficiencies in process by which price was arrived).

[95]*Solomon*, 672 A.2d at 39-40 (citing *Weinberger*, 457 A.2d at 703; *Lynch*, 351 A.2d at 576).

[96]Cole v. National Cash Credit Ass'n, 156 A. 183, 187 (Del. Ch. 1931).

[97]310 A.2d 904 (Del. Ch. 1973).

[98]*Id.* at 908 (citing Cole v. National Cash Credit Ass'n, 156 A. 183 (Del. Ch. 1931)).

[99]*See Eisenberg*, 537 A.2d at 1056-57.

[100]537 A.2d 1051 (Del. Ch. 1987).

> upon each stockholder's individual investment objectives and his evaluation of the merits of the offer. Moreover, tender offers often afford shareholders a unique opportunity to sell their shares at a premium above market price.[101]

The court in *Eisenberg* went on to enjoin a self-tender offer for the corporation's preferred stock, finding both disclosure violations and coercion.[102] The court found the tender offer was materially misleading because it did not adequately disclose, among other things, that certain directors had a potential conflict of interest by reason of their ownership of significant amounts of common stock.[103] Moreover, the court noted the fact that the tender price was represented as a 33% premium over the last reported sale price, but failed to point out that the last sales price was the lowest the stock had traded at in five years and the tender price was only a five percent premium over the average trading price.[104] The court found that the tender offer was coercive because the directors timed the offer to coincide with the lowest preferred stock price levels in five years and made a business judgment not to pay dividends on or redeem the preferred shares, so that the preferred stockholders might perceive that unless they tendered, they might not realize any return on or value for their investment in the foreseeable future, particularly, when they had been told the corporation intended to request listing of the shares on the New York Stock Exchange.[105] The court issued an injunction until adequate disclosures were made and the coercion was eliminated.[106]

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[101] *Id.* at 1056.

[102] *Id.* at 1062 (stating that a tender offer is not voluntary if the case involves materially false or misleading disclosures or where the the offer was wrongfully coercive).

[103] *Id.* at 1059-61.

[104] *Eisenberg*, 537 A.2d at 1059-61.

[105] *Id.* at 1061-62.

[106] *Id.* at 1063. Recently, the court of chancery held that when the challenged tender offer is the only one available, and enjoining the offer may cause the stockholders their only opportunity to obtain a premium on their investment, the court should grant the injunction only if satisfied that the plaintiff's legal claims are sound and there is a strong feeling that the risk to the stockholders is small. *In re* Cheyenne Software, Inc. Shareholders' Litig., No. 14,941 (Consolidated), 1996 Del. Ch. LEXIS 142, at *14-15 (Del. Ch. Nov. 7, 1996) (citing Solash v. Telex Corp., Nos. 9518, 9528, & 9525, 1988 Del. Ch. LEXIS 7 (Del. Ch. Jan. 19, 1988), *reprinted in* 13 DEL. J. CORP. L. 1250 (1988)). The potential for coercion is high in two-tier and partial tender offers. Jesse A. Finkelstein, *Antitakover Protection Against Two-Tier and Partial Tender Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions under Delaware Law*, 11 SEC. REG. L.J. 291, 293 (1984). In a two-tier tender offer, the acquiror first offers cash to obtain a majority interest in the target. *Id.* at 291. Simultaneously, the acquiror announces his or her intention to cash out the minority once a majority interest is acquired. *See, e.g.*, *Unocal*, 493 A.2d at 956. Consideration for the second tier cash out will

Valuation issues also arise in the context of mergers, consolidations, or other business combinations when disgruntled stockholders bring claims against the seller's board for breach of fiduciary duty.[107] Additionally, stockholders may assert claims against a purchaser for aiding and abetting a breach of fiduciary duty.[108] In these

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often be financed with junk bonds or lesser consideration. *See id.*; Finkelstein, *supra*, at 293 (discussing lesser consideration for second tier cash outs). Such offers are "classic coercive measure[s] designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction." *Unocal*, 493 A.2d at 956. These coercive techniques were often used in Delaware takeover transactions throughout the 1980s. *See, e.g.*, Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1342 (Del. 1987) (noting that the Ivanhoe offer "fit perfectly the mold of such a coercive device" similar to that found in *Unocal*); *Unocal*, 493 A.2d at 956 (finding the tender offer as both "coercive" and "inadequate"). *See also* Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 337 (1974) (urging public disclosure of acquiror's intent and a rule requiring same consideration in both steps of a transaction to protect stockholders from a two-tier takeover); Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964, 1966 (1984) (stating that "[t]he coercive nature of the two-tiered tender offer has been noted by courts, commentators, and an advisory committee of the Securities and Exchange Commission").

[107]*See, e.g.*, Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270 (Del. 1994) (claiming breach of duty of disclosure); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (involving breaches of duties of care and loyalty by directors); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (alleging breach of duty of care); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (claiming breach of duty of loyalty and unfair dealing); Behrens v. United Investors Management Co., No. 12,876, 1993 Del. Ch. LEXIS 217 (Del. Ch. Oct. 1, 1993) (alleging disclosure violation in valuation by board's investment banker).

[108]*See, e.g.*, *In re* Santa Fe Pac. Corp. Shareholders Litig., 669 A.2d 59 (Del. 1995); *In re* Tri-Star Pictures, Inc. Litig., 634 A.2d 319 (Del. 1993). Claims can be made against nonfiduciary third parties for aiding and abetting a breach of fiduciary duty if the third party "knowingly participated" in a breach of fiduciary duty by another. *Compare In re* Sea-Land Corp. Shareholders Litig. No. 8453, 1988 Del. Ch. LEXIS 65, at *14-15 (Del. Ch. May 13, 1988) *with* Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (private causes of action for aiding and abetting are not permitted under Rule 10b-5). Generally, such causes of action will lie only when the third party knew that the fiduciary's conduct amounted to a breach of fiduciary duty. *Sea-Land Corp.*, 1988 Del. Ch. LEXIS 65, at *14. However, the court of chancery has found that there are some circumstances in which the terms of a proposed transaction are so suspect that they should alert a third party that the transaction is the result of a breach of fiduciary duty. See, e.g., Fry v. Trump, 681 F. Supp. 252, 257 (D.N.J. 1988) (applying Delaware law, the court found that the plaintiffs produced sufficient evidence to support allegation of entrenchment by Bally's directors); *In re* Shoe-Town, Inc. Shareholders Litig., No. 9483, 1990 Del. Ch. LEXIS 14, at *20-22 (Del. Ch. Feb. 12, 1990); Gilbert v. El Paso Co., 490 A.2d 1050, 1056-57 (Del. Ch. 1984) ("Under Delaware law a nonfiduciary can be liable to the beneficiary of a fiduciary relationship for aiding and abetting the breach of a fiduciary's duty.") (citations omitted), *aff'd*, 575 A.2d 1131 (Del. 1990). For example, in *Gilbert v. El Paso*, a tender offeror was accused of aiding and abetting a breach of fiduciary duty by its target company's directors in connection with a

types of cases, the court may have to value the corporation and the stock in question in order to calculate a damage award.

An example of a breach of the duty of care is found in the Delaware Supreme Court's landmark decision *Smith v. Van Gorkom,*[109] where the court found that the board of directors of Trans Union Corporation breached its fiduciary duty of care by approving a proposed merger after only two hours of consideration, without adequately informing itself of the role of the corporate insider who had negotiated the merger, and without conducting an adequate inquiry into the company's intrinsic value. The court stated:

> Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing. But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.[110]

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merger agreement that contained terms that "clearly benefitted only [the target's] management and not its shareholders." *Gilbert*, 490 A.2d at 1056-57. The court found the tender offeror liable for aiding and abetting, holding that it was "chargeable with knowledge that [the target's] directors were preferring their interests to certain of its shareholders." *Id.* Thus, in some circumstances, a third party can be held liable for aiding and abetting even if he/she had no actual knowledge of the underlying breach of fiduciary duty. It is also worth noting that investment bankers may be deemed to have fiduciary duties beyond those set forth in their contracts. *See In re* Daisy Sys. Corp. v. Bear Stearns & Co., Inc., 97 F.3d 1171 (9th Cir. 1996).

Claims for aiding and abetting can be either derivative or class claims, depending upon the nature of the underlying fiduciary duty claim. *In re* Tri-Star Pictures Litig., No. 9477, 1990 Del. Ch. LEXIS 80 (Del. Ch. June 14, 1990), *rev'd in part*, 634 A.2d 319 (Del. 1993). A competing offeror who is also a stockholder may bring a claim alleging breach of fiduciary duty. *See, e.g.*, QVC Network, Inc. v. Paramount Communications, Inc., 635 A.2d 1245 (Del. Ch. 1993), *aff'd*, 637 A.2d 34 (Del. 1994).

[109]488 A.2d 858 (Del. 1985).

[110]*Id.* at 872 (citations omitted). *See also* Sealy Mattress Co. of N.J., Inc. v. Sealy, Inc., 532 A.2d 1324, 1337 (Del. Ch. 1987) (court of chancery enjoined merger of Sealy, Inc. imposed by its parent to "cash out" the plaintiffs who were the minority stockholders of Sealy because, in addition to functioning without expert financial or legal advice, "in approving the merger, [the directors of Sealy] were completely uninformed and made no effort to inform themselves of the material facts," including facts relevant to the fairness of the merger price such as previous offers and a previous investment banker's evaluation).

In *Van Gorkom*, the court held that in addition to breaching its duty of care, the board

After the case was remanded for a decision regarding damages, the parties entered into a settlement agreement that the court later approved whereby the corporation paid $23.5 million to the plaintiff stockholders.[111]

A cause of action for inadequate disclosure may be grounded on a breach of the duty of care and/or a breach of the duty of loyalty, and may be brought regardless of whether the fiduciary's misstatement or omission was intentional.[112] In many cases, these claims may center upon disclosures concerning the valuation of assets. In *Smith v. Shell Petroleum, Inc.*,[113] a case involving a cashout merger, an employee of Shell miscalculated the value of the company's oil and gas reserves by failing to account for close to 300 million barrel equivalents of proved oil and gas reserves.[114] These miscalculations resulted in an understatement of Shell's estimated discounted future net cash flows by approximately $1 billion (or roughly $3 per share) in materials that were disseminated to its stockholders.[115] The court found that the understatement of the

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had breached its fiduciary duty of disclosure by disseminating to stockholders proxy materials that: (1) falsely suggested that the board knew the company's intrinsic value, (2) mischaracterized a report submitted to the board regarding the value of the company's stock, (3) referred to a "substantial premium" without disclosing that the board had not adequately assessed that premium, and (4) presented an incomplete picture of the events leading up to the proposed transaction. *Van Gorkom*, 488 A.2d at 890-91. The court went on to hold that the board's supplementation of its initial proxy materials did not cure its breach of the fiduciary duty of disclosure:

> In short, the information disclosed by the Supplemental Proxy Statement was information which the defendant directors knew or should have known at the time the first Proxy Statement was issued. The defendants simply failed in their original duty of knowing, sharing, and disclosing information that was material and reasonably available for their discovery. . . . While we need not decide the issue here, we are satisfied that, in an appropriate case, a completely candid but belated disclosure of information long known or readily available to a board could raise serious issues of inequitable conduct.

Id. at 893 (citations omitted).

[111]*See* Smith v. Van Gorkom, No. CIV.A.6342, 1985 WL 22040, at *1 (Del. Ch. Oct. 11, 1985).

[112]If the corporation should have known about the error, even negligent or innocent misrepresentations may give rise to a cause of action for breach of the duty of disclosure. *See, e.g.*, Gaffin v. Teledyne, Inc., No. 5786, 1990 Del. Ch. LEXIS 198, at *17 (Del. Ch. Dec. 4, 1990), *rev'd in part on other grounds*, 611 A.2d 467 (Del. 1992); *Smith*, 1990 Del. Ch. LEXIS 82, at *37-46, *reprinted in* 16 DEL. J. CORP. L. at 892-97; Cavalcade Oil Corp. v. Texas Am. Energy Corp., No. 7605, 1984 WL 8215, at *1 (Del. Ch. May 22, 1984), *reprinted in* 9 DEL. J. CORP. L. 417, 418 (1984).

[113]No. 8395, 1990 Del. Ch. LEXIS 82, at *37-46 (Del. Ch. Nov. 26, 1990), *aff'd*, 606 A.2d 112 (Del. 1992).

[114]*Id.* at *27-28.

[115]*Id.* at *28.

reserves "would have been viewed by a reasonable investor as significantly altering the 'total mix' of information available" to the stockholders, and was thus a material misdisclosure giving rise to liability for breach of the fiduciary duty of disclosure.[116] The court rejected the defendant's argument that it should not be held liable for the misdisclosure because it did not know about the error at the time the materials were distributed to the stockholders, holding that "[l]iability for the error . . . turns not on whether [the company] knew about the error, but whether [the company] should have known about it."[117] The court approved a settlement offer awarding $2 per share to the plaintiff shareholders to remedy the injury arising from the defendant's failure to properly disclose the oil and gas reserves which induced the stockholders to accept an inadequate price.[118]

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[116]*Id.* at *35.

[117]*Smith*, 1990 Del. Ch. LEXIS 82, at *50-51.

[118]*Id.* at *21-22. In Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270 (Del. 1994), the court held that the board of directors had breached its duty of disclosure by failing to fully explain the history behind a proposed merger in its proxy materials. *Id.* at 1280. Specifically, the court found that the proxy statement detailed certain aspects of the merger negotiation process, but contained no reference to a contingent $275 million bid that had been made for the company. *Id.* at 1281. The court found the board's partial disclosures regarding the history of the merger negotiations to have rendered the $275 million bid material, such that its nondisclosure made the proxy statement misleading. *Id.* at 1280. The court noted in dicta that, had the board not undertaken to partially disclose the history of the merger negotiations, the $275 million bid might not have been material. *Id.* at 1277, 1280. As the court explained: "[O]nce defendants traveled down the road of partial disclosure of the history leading up to the Merger and used the vague language described, they had an obligation to provide the stockholders with an accurate, full, and fair characterization of those historic events." *Id.* at 1280.

The court in *Arnold* also distinguished between negligent or innocent misrepresentations and intentional misrepresentations, noting that where the omission or misstatement was intentional or made under circumstances amounting to equitable fraud, such conduct rises to the level of a breach of the fiduciary duty of loyalty. *See id.* at 1287-88; *see also* Zirn v. VLI Corp., 621 A.2d 773, 783 (Del. 1993) (holding that articles in a corporation's certificate of incorporation "which purport to protect directors from monetary liability for breaches of fiduciary duty, does not shield directors from liability for equitable fraud"). The characterization of a misdisclosure as a breach of the duty of loyalty has significant implications, as a corporation may shield its directors from personal liability for breaches of the duty of disclosure but not for breaches of the duty of loyalty. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1994); *Arnold*, 650 A.2d at 1287. Prior to the Delaware Supreme Court's opinion in *Arnold*, disclosure claims were typically treated as arising out of the duty of loyalty. *See, e.g., Zirn*, 621 A.2d at 783 (stating that duty of loyalty embraces duty of disclosure).

It is also not necessary for a stockholder alleging breach of the duty of disclosure to demonstrate actual reliance on the alleged inadequate disclosure. *Gaffin*, 611 A.2d at 472. This is an important feature of fiduciary duty of disclosure claims, particularly in light of the Delaware Supreme Court's pronouncement that Delaware law does not permit certification of class action suits based upon common law fraud because the facts surrounding the element of

With regard to the duty of loyalty, another landmark decision by the Delaware Supreme Court is *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[119] In *Revlon*, the court affirmed the court of chancery's decision to enjoin certain measures taken by the Revlon Board to thwart a potential takeover by Pantry Pride because the board had breached its fiduciary duty of loyalty by making concessions to its preferred bidder rather than attempting to obtain the best price for Revlon's stockholders.[120] The court held that once a board of directors concludes that a sale of the company is inevitable, its role shifts "from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[121] In this mode, valuation issues must be confronted by the directors, and later by the stockholders, to determine if this standard has been met.

As previously indicated, valuation is not just limited to the damages stage of a case, but can also, and often does, go to the heart of liability. For example, in Delaware, decisions of a corporation's board of directors are presumed to be the product of a valid business judgment

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reliance are necessarily individualized and not common to all members of a proposed class. *Id.* Because reliance is not an element of fiduciary duty claims, it does not present an obstacle to certification of a stockholder class action suit based upon false or inadequate disclosures. *See Zirn*, 621 A.2d at 783 ("so long as the fiduciary claims survive, class certification continues to be appropriate"); Iseman v. Liquid Air Corp., No. 9694, 1993 Del. Ch. LEXIS 24, at *5 n.2, *10 (Del. Ch. Feb. 11, 1993), *reprinted in* 18 DEL. J. CORP. L. 1025, 1029 n.2, 1031 (1993) (asserting that "[t]he Supreme Court's decision in *Gaffin* does not impact on the pending motions in this action because here, unlike in *Gaffin*, the claim is one for breach of fiduciary duty" and granting motion for class certification in a case involving breach of the fiduciary duty of disclosure).

[119]506 A.2d 173 (Del. 1986).

[120]*Id.* at 175-76. *See also* Summa Corp. v. Trans World Airlines, Inc., 540 A.2d 403, 404 (Del. 1988) (affirming substantial monetary judgment for breach of duty of loyalty by controlling majority shareholder that purposefully interfered with TWA's ability to enter into financially sound contracts and manipulated terms of TWA's lease and purchase contracts to the detriment of TWA but to its own benefit), *cert. denied*, 488 U.S. 853 (1988); Guth v. Loft, 5 A.2d 503 (Del. 1939) (upholding decision finding that director breached fiduciary duty of loyalty by using corporate funds and resources to acquire Pepsi-Cola trademark and formula for himself without affording corporation an opportunity to do so).

[121]*Revlon*, 506 A.2d at 182. In such situations, the directors are obligated to act pursuant to their fiduciary duties of care and loyalty to obtain the best possible value for the stockholders. *Paramount*, 637 A.2d at 46; *Revlon*, 506 A.2d at 182. In evaluating a proposed sale, however, the board need not focus solely on the amount of cash to be received by stockholders in the transaction, but may consider other factors such as: the noncash consideration to be transferred; the future value of the target company's alliance with the potential acquiror; the fairness or feasibility of the offer; the financing of the offer; the risk of nonconsummation of the sale; the identity and history of the acquiror; the acquiror's other business ventures; and the acquiror's intentions with respect to the future of the target company. *Paramount*, 637 A.2d at 44 (citing *Mills Acquisition*, 559 A.2d at 1282 n.29).

(i.e., the "business judgment rule").[122] This presumption can be rebutted by, among other ways, establishing that the directors breached their duty of care or that the decision was approved by directors who had an interest in the transaction. If the business judgment rule is rebutted, the burden then shifts to the board of directors to establish that the transaction was entirely fair.[123] In an entire fairness case, fair price may actually be an

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[122]Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). In evaluating the merits of a cause of action for breach of fiduciary duty filed against a corporation's directors with respect to decisions made or actions taken by those directors, the Delaware courts will ordinarily apply the "business judgment rule" which creates a rebuttable presumption that, in making the business decision in question, the directors acted in good faith, on an informed basis, and in the honest belief that the decision was in the corporation's best interests. *Van Gorkom*, 488 A.2d at 872; *Aronson*, 473 A.2d at 812. The court will not substitute its own business judgment for the board's and impose personal liability upon the directors unless the evidence indicates that they acted in bad faith or in a grossly negligent fashion. *Van Gorkom*, 488 A.2d at 872-873; *Aronson*, 473 A.2d at 812; *Sinclair Oil Corp.*, 280 A.2d at 720. As the Delaware Supreme Court stated in Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361 (Del. 1995), "[T]he business judgment rule shields directors from personal liability if, upon review, the court concludes the directors' decision can be attributed to any rational business purpose." *Id.* at 1374 (citing *Sinclair Oil Corp.*, 280 A.2d at 720). Because the business judgment rule creates a rebuttable presumption with respect to the making of business decisions, it is inapplicable to claims not arising as a result of such decisions, such as claims alleging breaches of the fiduciary duty of disclosure. Estate of Detwiler v. Offenbecher, 728 F. Supp. 103, 150 n.18 (S.D.N.Y. 1989); *In re* Anderson, Clayton Shareholders' Litig., 519 A.2d 669, 675 (Del. Ch. 1986) ("[T]he question whether shareholders have, under the circumstances, been provided with appropriate information upon which an informed choice on a matter of fundamental corporate importance may be made, is not a decision concerning the management of business and affairs of the enterprise of the kind the business judgment rule is intended to protect. . . .") (citation omitted). The presumptions of the business judgment rule do not apply in actions brought against corporate officers, as opposed to directors. *See* Platt v. Richardson, No. CIV.A.88-0144, 1989 WL 159584, at *2 (M.D. Pa. June 6, 1989) (holding that the defendant, in his capacity as an officer of SECCO, was not entitled to the presumption of reasonableness with respect to his business decisions involving SECCO).

[123]Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995); *Mills Acquisition*, 559 A.2d at 1279-80; AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986). This standard — which has proven difficult for directors to meet — requires the directors to show not only that the transaction was for a fair price, but also that it was the result of fair dealing. *Mills Acquisition*, 559 A.2d at 1280; *Weinberger*, 457 A.2d at 711.

In situations where one or more directors has a personal interest in a proposed transaction, it is common for corporations to appoint special committees of disinterested directors to evaluate the transaction. If such a committee is a properly functioning committee and meets certain rigorous requirements, a transaction approved by a majority of the members of that committee will be afforded the protections of the business judgment rule. *See, e.g.*, *Mills Acquisition*, 559 A.2d at 1279-80 (holding that when a court is confronted with a breach of duty challenge of a board action, it will decline to evaluate the wisdom behind such a decision unless the record demonstrates that the decision was not the "product of an informed, disinterested, and independent board"); *Resorts Int'l*, 1988 Del. Ch. LEXIS 130, at *17-19,

issue in establishing liability.[124] Entire fairness includes both fair dealing and fair price.[125] Fair dealing "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[126] Fair price "relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's

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reprinted in 14 DEL. J. CORP. L. at 840-41 (holding that this disinterested board or special committee, which was informed, expertly advised, and made a decision, was entitled to the presumptions and protection of the business judgment rule), *aff'd*, 570 A.2d 259 (Del. 1990); *cf.* Freedman v. Restaurant Assoc. Indus., Inc., No. 9212, 1990 Del. Ch. LEXIS 142, at *21-23 (Del. Ch. Sept. 21, 1990), *reprinted in* 16 DEL. J. CORP. L. 1462, 1275-76 (1991) (finding that the special committee held to "entire fairness" standard where committee was not fully functional and was restricted by management).

[124]*Cinerama*, 663 A.2d at 1163; *Weinberger*, 457 A.2d at 711.

[125]*Cinerama*, 663 A.2d at 1162 (citing *Weinberger*, 457 A.2d at 711). In Pinson v. Campbell-Taggart, Inc., No. 7499, 1989 Del. Ch. LEXIS 50 (Del. Ch. Feb. 28, 1989) (revised Apr. 21, 1989, Aug. 11, & Nov. 28, 1989), *reprinted in* 14 DEL. J. CORP. L. 1095 (1989), the court of chancery explained the rationale for the entire fairness standard as follows:

> [T]he rationale for imposing the "entire fairness" burden is that in a self dealing transaction, the minority shareholders' interests are not being adequately safeguarded, because the fiduciaries charged with protecting the minority have a conflicting self-interest. Our law, therefore, creates compensating procedural safeguards by subjecting those fiduciaries to the exacting requirement that they demonstrate to a carefully scrutinizing court "their utmost good faith and the most scrupulous inherent fairness of the bargain."

Id. at *16, *reprinted in* 14 DEL. J. CORP. L. at 1106-07 (quoting *Weinberger*, 457 A.2d at 710).

[126]*Weinberger*, 457 A.2d at 711. In Sealy Mattress Co. of N.J. v. Sealy, Inc., 532 A.2d 1324 (Del. Ch. 1987), the court stated:

> As fiduciaries seeking to "cash out" the minority stockholders of a Delaware corporation in a non-arm's length merger, the defendants had a duty to be entirely and scrupulously fair to the plaintiffs in all respects. The majority stockholder was obliged not to time or structure the transaction, or to manipulate the corporation's values, so as to permit or facilitate the forced elimination of the minority stockholders at an unfair price. The corporation's directors were obliged to make an informed, deliberate judgment, in good faith, that the merger terms, including the price, were fair and that the merger would not become a vehicle for economic oppression. And finally, the directors (and the majority stockholder, to the extent that it involved itself in such matters) were obliged to disclose with entire candor all material facts concerning the merger, so that the minority stockholders would be able to make an informed decision as to whether to accept the merger price or to seek judicial remedies such as appraisal, an injunction, or a post-merger damage action.

Id. at 1335 (citation omitted).

stock."[127] Thus, the "fair price" prong of the entire fairness standard requires a board to establish that, with regard to the sale of a company, the price involved was the highest value reasonably available.[128] Consequently, valuation issues must then be addressed at the liability stage to determine whether or not the board has met its obligations.[129]

In either a tender offer, merger, or similar situation in which a breach of fiduciary duty is alleged, if liability is established the court may award any form of relief it deems appropriate.[130] This may include an injunction[131] or an accounting and, as will be discussed, any of the following forms of damages:[132] (1) actual damages - the difference

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[127]*Weinberger*, 457 A.2d at 711.

[128]*Cinerama*, 663 A.2d at 1163.

[129]*See* Kahn v. Lynch Communication Sys., Inc., 669 A.2d 79, 88 (Del. 1995) (affirming the decision that the transaction was entirely fair to the minority shareholders after the burden of proving fair merger price had shifted to the controlling shareholder and a sufficient showing of fair value of the company was presented).

[130]*Weinberger*, 457 A.2d at 714-15 (holding that the chancellor has broad discretion to provide such relief as the facts of a given case warrant).

[131]A request for an injunction will be governed by the traditional test applicable to such requests and a "plaintiff must show a reasonable probability of success on the merits, a reasonable likelihood of irreparable harm if injunctive relief is not granted, and that the harm to the plaintiff if injunctive relief is denied outweighs the harm to the defendants if relief is granted." *Eisenberg*, 537 A.2d at 1055-56 (citing *Revlon*, 506 A.2d at 179; Gimbel v. Signal Co., 316 A.2d 599, 602-03 (Del. Ch. 1974), *aff'd*, 316 A.2d 619 (Del. 1974)).

[132]As a preliminary matter, one important issue that cannot be ignored when discussing damages recoverable in actions for breach of fiduciary duty is the ability of a corporation, pursuant to section 102(b)(7) of the Delaware General Corporation Law to include a provision in its certificate of incorporation eliminating its directors from personal liability for damages as a result of their breaches of the fiduciary duty of care. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1994). If a corporation has adopted such a provision, its directors — but not its officers — will have an affirmative defense to any claims brought against them for damages resulting from a violation of the duty of care. *See* Rothenberg v. Santa Fe Pac. Corp., No. 11,749, 1992 Del. Ch. LEXIS 106, at *10-14 (Del. Ch. May 18, 1992), *reprinted in* 18 DEL. J. CORP. L. 743, 751-53 (1993) (holding that, because Santa Fe has adopted a provision modeled after § 102(b)(7), it has an affirmative defense against claims for damages for duty of care violations). Note that a provision adopted pursuant to § 102(b)(7) does not provide a defense to the underlying claim for breach of fiduciary duty, but only to the awarding of damages. *Id.* at *13-14, *reprinted in* 18 DEL. J. CORP. L. at 753. In addition, the official commentary to § 102(b)(7) explains that "[t]his provision would have no effect on the availability of equitable remedies, such as injunction or rescission, for breach of fiduciary duty." However, a provision adopted pursuant to § 102(b)(7) will preclude liability for quasi-equitable remedies that involve monetary damages, such as rescissory damages or "nominal" damages on a per-share basis. *See* Arnold v. Society for Sav. Bancorp, Inc., 678 A.2d 533, 541-42 (Del. 1996) (holding that, where stockholders enact the charter provision authorized by § 102(b)(7), exempting directors from liability, directors are free from personal financial liability whether monetary damages arise out of legal or equitable theories). A corporation can also shield its directors from liability for unintentional breaches of the fiduciary duty of disclosure. *Arnold*, 650 A.2d at

between fair consideration and consideration received, (2) rescissory damages, or (3) per se damages - representing damage for the breach itself.[133]

2. Breach of Fiduciary Duty Damage Standards

Claims involving fraud, misrepresentation, self-dealing, deliberate waste of corporate assets,[134] overreaching, or other breaches of fiduciary

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1288. Importantly, however, a corporation cannot eliminate its directors from liability for breaches of the fiduciary duty of loyalty, including breaches of the fiduciary duty of disclosure that amount to equitable fraud. DEL. CODE ANN. tit. 8, § 102(b)(7) (1994); *Zirn*, 621 A.2d at 783.

[133]*See Tri-Star Pictures*, 634 A.2d at 333-34 (holding that the measure of loss is not necessarily limited to the difference between the offered price and the appraisal value but any form of equitable and monetary relief may be appropriate, including rescissory damages); *Weinberger*, 457 A.2d at 714 (finding that, where the appraisal remedy may not be adequate, the chancellor has the power to fashion any form of appropriate relief, including rescissory damages). Even if damages may be difficult to determine, the court may award nominal damages for the breach of duty itself based upon the equitable maxim that equity will not suffer a wrong without a remedy. *See, e.g.*, Weinberger v. UOP, Inc., No. CIV.A.5642, 1985 WL 11546 (Del. Ch. Jan. 30, 1985), *reprinted in* 10 DEL. J. CORP. L. 945 (1985) (awarding $1 per share to minority sharheolders), *aff'd*, 497 A.2d 792 (Del. 1985). In direct actions, stockholders alleging breaches of fiduciary duty may recover monetary damages from the individual officers or directors who committed those breaches. In derivative suits, on the other hand, any damage recovery inures to the corporation on whose behalf the suit was filed, rather than to the plaintiff stockholder personally. For this reason, any settlement of a derivative suit requires approval by the court of chancery, and cannot be agreed to by the stockholder plaintiff alone. *See* DEL. CH. CT. R. 23.1 ("The action shall not be dismissed or compromised without approval of the Court."). The court will approve a settlement if it is convinced that, in its own business judgment, the settlement is fair and reasonable under the circumstances. Polk v. Good, 507 A.2d 531, 535-36 (Del. 1986) (noting that the chancellor applied his own business judgment in concluding that the settlement was reasonable in light of the circumstances). A successful shareholder derivative plaintiff can, nevertheless, secure an award of attorneys' fees when his/her efforts have benefitted the corporation or its stockholders at large. *Id.* at 535.

[134]It has been deemed to be a breach of fiduciary duty for a board of directors to enter into a transaction in which the consideration received by the corporation is so inadequate that no person of ordinary sound business judgment would have entered into the transaction because such a transaction would constitute an impermissible waste of corporate assets. *See, e.g.*, Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962) (finding that where waste or corporate assets is alleged, the court must examine the facts of the situation and determine whether what the corporation received was so inadequate that no person of ordinary, sound business judgment would declare it worth what the corporation paid); Stein v. Orloff, No. CIV.A.7276, 1985 WL 11561, at *5 (Del. Ch. May 30, 1985), *reprinted in* 11 DEL. J. CORP. L. 312, 319 (1986) (holding that there was sufficient facts to state a claim for waste, which created a reasonable doubt that the transaction was the result of a valid exercise of business judgment). This concept is illustrated by the holding in Emerald Partners v. Berlin, No. CIV.A.9700, 1993 WL 545409 (Del. Ch. Dec. 23, 1993), *reprinted in* 19 DEL. J. CORP. L. 1182 (1994), where the court found that a shareholder had stated a viable claim for "waste" against the directors of the

duty are not subject to the same restrictions as are statutory appraisal actions.[135] In cases involving a breach of fiduciary duty, establishing the breach may be sufficient to sustain a cause of action even without any proof of injury.[136] Thus, actions asserting fraud, unfair dealing, unfair price, etc., afford an "expansive remedy" against the wrongdoers for whatever relief the facts of a particular case may require,[137] and the court may "'fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages.'"[138]

Frequently, monetary damages resulting from a breach of fiduciary duty are difficult to measure, or would otherwise not provide adequate relief. In such cases, there are a broad range of equitable remedies available to stockholders in Delaware's Court of Chancery, including injunctive and rescissory relief.[139] If a breach of fiduciary duty has resulted in steps being taken toward the consummation of an unfair or improper transaction, a stockholder may obtain an order from the court enjoining the consummation of that transaction. If the transaction has already been completed, a stockholder may seek rescission of that transaction.[140]

There are, of course, situations in which, although actual damages are difficult to calculate, injunctive relief and/or rescission are not practical.[141] If the fiduciary has profited from his or her wrongdoing, monetary damages representing restitution based on a theory of "unjust enrichment" may be appropriate.[142] As the court stated in *Oberly v.*

Hall Group, where the complaint alleged that the directors had agreed to pledge corporate assets to secure the majority stockholder's personal loan in exchange for nothing more than a promise to indemnify the corporation in the event of a foreclosure on the pledged assets. *Id.* at *6-7, *reprinted in* 19 DEL. J. CORP. L. at 1191-93.

[135]*Weinberger*, 457 A.2d at 714. *See also Technicolor II*, 634 A.2d at 371 ("we emphasize that the measure of any recoverable loss . . . 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").

[136]*Technicolor II*, 634 A.2d at 371.

[137]*Technicolor I*, 542 A.2d at 1187.

[138]*Technicolor II*, 634 A.2d at 371 (quoting *Weinberger*, 457 A.2d at 714).

[139]*See supra* notes 131-32 and accompanying text.

[140]*Weinberger*, 457 A.2d at 714.

[141]*See* Winston v. Mandor, No. 14,807, 1996 Del. Ch. LEXIS 135 (Del. Ch. Oct. 25, 1996) (discussing infeasibility of rescission as remedy).

[142]*See* Thorpe v. CERBCO, Inc., 676 A.2d 436, 444 (Del. 1996) (requiring directors to disgorge profits resulting from their usurpation of a corporate opportunity for their own benefit, where transactional damages were inappropriate since the defendant directors were also controlling shareholders with the statutory power to have caused the corporation reject the opportunity if presented with it); *In re* Tri-Star Pictures, Inc. Litig., No. 9477 (Consolidated), 1992 Del. Ch. LEXIS 30, at *17-18 (Del. Ch. Feb. 21, 1992), *reprinted in* 18 DEL. J. CORP.

Kirby:[143]

> [T]he absence of specific damage to a beneficiary is not the sole test for determining disloyalty by one occupying a fiduciary position. It is an act of disloyalty for a fiduciary to profit personally from the use of information secured in a confidential relationship, even if such profit or advantage is not gained at the expense of the fiduciary. The result is nonetheless one of unjust enrichment which will not be countenanced by a Court of Equity.[144]

As a corollary to restitutionary damages, at least in actions for breach of the duty of loyalty,[145] the Delaware Supreme Court has held that rescissory damages should be considered as an alternative when actual damages and rescission are impractical.[146] As the court of chancery has stated:

> [A]n award of rescissory damages would be most appropriate where it is shown that the defendant fiduciaries unjustly enriched themselves by exercising their fiduciary authority deliberately to extract a personal financial benefit at the expense of the corporation's shareholders.[147]

L. 347, 358 (1993) (explaining that a restitutionary theory of "unjust enrichment," which is based on a fiduciary profiting from a breach of duty, is distinguished from a theory of compensation for harm or damage done because the recovery consists of the profit improperly obtained), *rev'd in part on other grounds*, 634 A.2d 319 (Del. 1993).

[143]592 A.2d 445 (Del. 1991).

[144]*Id.* at 463.

[145]The court of chancery has suggested in dicta that rescissory damages are inappropriate in cases involving breaches of the duty of care:

> [R]escissory damages should never be awarded against a corporate director as a remedy for breach of his duty of care alone; that remedy may be appropriate where a breach of the directors duty of loyalty has been found, . . . but neither principle nor authority supports the awarding of rescission or a substitute for it against one who neither participates in the deal as a principal nor, is a co-conspirator of a principal or has a material conflict of interest of another sort.

Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1144 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995) (citations omitted). The court's discussion of its reasoning behind this conclusion suggests, however, that rescissory damages may be permitted in duty of care cases where directors engaged in intentional misconduct as opposed to mere negligence. *Id.* at 1147-49.

[146]*Weinberger*, 457 A.2d at 714; *see also Lynch*, 429 A.2d at 501 (concluding that the best result would not be accomplished by a rescission but rather by ordering damages which are the monetary equivalent for rescission).

[147]Ryan v. Tad's Enters., Inc., Nos. 10,229 & 11,977, 1996 Del. Ch. LEXIS 54, at *48

Rescissory damages are intended to provide the plaintiff with the monetary equivalent of a rescission of the transaction (i.e., to place the stockholder plaintiff in the same financial position he or she would have been in had the transaction not been consummated).[148] Like rescission, however, rescissory damages are an equitable remedy that can be waived if the plaintiff unnecessarily delays in requesting it.[149] For example, in *Lynch v. Vickers Energy Corp.*,[150] where the majority stockholder breached the duty of disclosure to the minority stockholders in connection with a tender offer in which it purchased shares from those stockholders, but where rescission was not feasible because the corporation had been merged and other significant corporate changes had occurred prior to the time of judgment, the court ordered the majority stockholder to pay rescissory damages to the plaintiff minority stockholders in an amount equal to the value of their stock at the time of judgment.[151]

In actions involving inadequate disclosure by a corporate fiduciary, both actual damages and rescissory damages are often particularly difficult to measure. However, the court of chancery recognizes that monetary damages are still appropriate in such cases since the stockholders have been deprived of the opportunity to make an informed decision regarding corporate matters.[152] In the absence of some other indication of the value of that lost opportunity, the court has entered

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(Del. Ch. Apr. 24, 1996), *reprinted in* 21 DEL. J. CORP. L. 1235, 1261 (1996).

[148]*Lynch*, 429 A.2d at 501-02; *Cinerama*, 663 A.2d at 1144. Such damages are available when rescission of the transaction "would be appropriate, but is not feasible." *Id.* In *Cinerama*, the court held that rescissory damages should never be awarded for breach of the duty of care alone. *Id.* The court then engaged in a lengthy discussion regarding the difficulty in assessing rescissory damages and whether they are a form of restitution representing the fair value of stock at the time of judgment or a form of compensatory damages with roots in trust law. *Id.* at 1144-49.

[149]*Ryan*, 1996 Del. Ch. LEXIS 54, at *50-51, *reprinted in* 21 DEL. J. CORP. L. at 1262-63.

[150]429 A.2d 497 (Del. 1981).

[151]*Id.* at 501-03. The court went on to explain that the rescissory damages were to be determined as of the date the trial on damages ended because that was the date on which the parties had agreed to close the record and was the date by which damages "are ordinarily proved." *Id.* at 505. The court ordered the lower court, on remand, to determine an appropriate value for the stock as of that date, and to consider a per-share price between $15.00 (the amount the majority stockholder had authorized paying per share in open market purchases just prior to the tender offer) and $41.40 (the maximum amount assigned to the stock by plaintiffs' experts). *Id.* The majority stockholder was also found to be entitled to a credit of $12.00 per share (the amount paid to the plaintiffs in the tender offer) plus interest on that sum in the hands of the plaintiffs. *Id.* at 506.

[152]*Weinberger*, 1985 WL 11546, at *1-2, *reprinted in* 10 DEL. J. CORP. L. at 947-49, *aff'd*, 497 A.2d 792 (Del. 1985).

damage awards on a per-share basis, such as $1.00 or $2.00 per share.[153] Thus, in Delaware, the law has evolved "into a virtual *per se* rule of damages for breach of the fiduciary duty of disclosure" because "the courts recognize[] some value associated with a stockholder's right to make an informed decision on corporate affairs."[154] In *Weinberger*, the court ordered damages of $1.00 per share because of evidence that if the stockholders had voted down the proposed cash merger on complete disclosure the majority stockholder would have acquired plaintiffs' shares at $22.00 instead of $21.00 per share.[155] In its decision, the court held that "the minority should be compensated for the wrong done to them even though a damage figure cannot be ascertained from a comparison of selected stock values with any degree of precision" because "equity will not suffer a wrong without a remedy."[156]

Unlike an appraisal action, in a successful breach of fiduciary duty or fraud claim, a stockholder might be entitled to a control premium. For example, with regard to a sale of control, a board of directors must exercise their fiduciary duties "to secure the transaction offering the best

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[153]*Gaffin*, 1990 Del. Ch. LEXIS 198, at *52 (holding that the damages of $1 per share were appropriate); *Smith*, 1990 Del. Ch. LEXIS 190, at *13-14 (holding that due to the minor disclosure violations, $2 per share was an appropriate measure of damages), *aff'd*, 606 A.2d 112 (Del. 1992); *Weinberger*, 1985 WL 11546, at *9-10, *reprinted in* 10 DEL. J. CORP. L. at 957-60 (holding that based upon the court's discretion in making an award of monetary damages and the entire fairness standard, the plaintiffs were awarded $1 per share plus interest), *aff'd*, 497 A.2d 792 (Del. 1985). In *Weinberger*, the court of chancery stated:

> Accordingly, I interpret the Supreme Court's finding of unfair dealing on Signals' part — which I take to be a finding of misrepresentation — and its direction with regard to an award, if any, of monetary damages on remand, to mean that the Court is free in its discretion to award such monetary damages as it deems appropriate to the situation without being limited in arriving at a damage figure, or the lack of one, to a dollar and cents comparison between the $21 per share price paid to the minority in the merger and some other specific per share value of the UOP stock either as of the merger date or at some subsequent time. In short, I do not deem it to be my function under the particular circumstances of this case to restrict my conclusion to the results of an appraisal of the value of a share of UOP stock either at the merger date or at some other date.

Weinberger, 1985 WL 11546, at *2, *reprinted in* 10 DEL. J. CORP. L. at 948-49.

[154]*Tri-Star Pictures*, 634 A.2d at 333-34. *See also Smith*, 1990 Del. Ch. LEXIS 190, at *13-14 (holding that based on disclosure violations shareholders would be awarded $2 per share). *But see Gaffin*, 611 A.2d at 475-76 (questioning whether "supportable basis" existed for $1 per share award on claims of omission of material facts in repurchase program where plaintiff's expert testimony "failed to support the level of damages sought").

[155]*Weinberger*, 1985 WL 11546, at *2-3, *reprinted in* 10 DEL. J. CORP. L. at 948-50.

[156]*Id.* at *9, *reprinted in* 10 DEL. J. CORP. L. at 957.

value reasonably available for the stockholders."[157] In *Paramount Communications v. QVC Network*,[158] the Delaware Supreme Court recognized that:

> [t]he acquisition of majority status and the consequent privilege of exerting the powers of majority ownership come at a price. That price is usually a control premium which recognizes not only the value of a control block of shares, but also compensates the minority stockholders for their resulting loss of voting power.[159]

Consequently, the court stated that "the Paramount stockholders are entitled to receive, and should receive, a control premium and/or protective devices of significant value."[160] Similarly, in *Cinerama, Inc. v. Technicolor, Inc.*,[161] the court alluded to the potential award of damages that reflected aspects of a control premium: "In order to make a compensatory award the court would have to conclude that there was some creditable basis in the evidence to find that a price higher than $23 per share was reasonably likely to have emerged if the directors had sought it out."[162] In dealing with the particular facts before it, the court stated that "opinion evidence, unsupported by some evidence that a bidder would actually have been interested in paying such a price, provides a frail, and here inadequate, support for a damage award."[163] By its language, however, the court suggested that a damage award in a breach of fiduciary duty case might properly contain a control premium where there is reliable evidence that such a premium would have been obtained in the market but for the breach of duty.

With regard to valuation, however, the actual valuation methodologies employed in breach of fiduciary duty cases are the same as in appraisal proceedings. As the Delaware Supreme Court has stated:

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[157] *Paramount*, 637 A.2d at 44. Board action is subject to enhanced scrutiny in these circumstances. *Id.* at 45.

[158] 637 A.2d 34 (Del. 1993).

[159] *Id.* at 43. *See also Eisenberg*, 537 A.2d at 1056, 1063 (acknowledging stockholders' ability to obtain control premium); John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 360 (1996) ("At first glance, few corporate law principles seem to be better established than the widely prevailing rule that a controlling shareholder may receive a control premium for its shares.").

[160] *Paramount*, 637 A.2d at 43.

[161] 663 A.2d 1134 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995).

[162] *Id.* at 1150.

[163] *Id.*

> This Court in *Weinberger* recognized that "[i]n this breach of fiduciary duty case, the Chancellor perceived that the approach to valuation was the same as that in an appraisal proceeding." Although this Court overruled the exclusivity of the method used by the Chancellor, we did not reverse the Chancellor's decision to use the appraisal valuation approach for cases involving breaches of fiduciary duties.[164]

C. *Acquisition Disputes*

1. Fraud and Breach of Contract/Warranty

There are many additional and different types of claims available to purchasers, sellers, and even third-parties[165] arising from acquisitions

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[164]*Technicolor I*, 542 A.2d at 1187 n.9 (quoting *Weinberger*, 457 A.2d at 712). In Rabkin v. Olin Corp., No. 7547 (Consolidated), 1990 Del. Ch. LEXIS 50 (Del. Ch. Apr. 17, 1990), *reprinted in* 16 DEL. J. CORP. L. 851 (1991), *aff'd*, 586 A.2d 1202 (Del. 1990), the court observed:

> It seems unmistakably clear from *Weinberger* that the determination of fair price in an entire fairness proceeding is the same as the determination of fair price in an appraisal proceeding. After noting the considerations implicated in a fairness analysis as it relates to price, the Supreme Court cited an article that states: "The second aspect of fairness deals with the concept of fair price, and I think we would be safe to refer to the large body of appraisal law that pertains to the intrinsic value of stock."

Id. at *12 n.4, *reprinted in* 16 DEL. J. CORP. L. at 858 n.4 (quoting Andrew G.T. Moore, *The "Interested" Director or Officer Transaction*, 4 DEL. J. CORP. L. 674, 676 (1979)).

[165]In addition to fraud, misrepresentation, breach of contract, and breach of warranty, claims might be based on federal and state statutory law, including violations of federal securities laws, state securities laws or "Blue Sky" laws, the federal Racketeer Influenced and Corrupt Organizations Acts and state Racketeer Influenced and Corrupt Organizations Acts. *See, e.g.*, Delta Holdings, Inc. v. National Distillers & Chem. Corp., 945 F.2d 1226, 1239 (2d Cir. 1991) (plaintiff asserted claims for breach of warranty, fraud and deceit, securities violations, racketeering, state business law violations, and negligent misrepresentation), *cert. denied*, 503 U.S. 985 (1992); Sound Video Unlimited, Inc. v. Video Shack, Inc., 700 F. Supp. 127, 132 (S.D.N.Y. 1988) (plaintiff asserted claims for racketeering, fraud, conversion, breach of fiduciary duty, breach of contract, promissory estoppel, and securities violations); Willco Kuwait (Trading) S.A.K. v. DeSavary, 638 F. Supp. 846, 849 (D.R.I. 1986), *remanded in part, aff'd in part*, 843 F.2d 618 (1st Cir. 1988) (plaintiff asserted claims for fraud and securities violations); McGuire v. Wilson, No. 8156 (RWS), 1990 U.S. Dist. LEXIS 12,760, at *1-2 (S.D.N.Y. Sept. 28, 1990) (plaintiff asserted claims for breach of contract, rescission, securities violations, fraud, negligence, and breach of fiduciary duty); Sperau v. Ford Motor Co., 674 So. 2d 24, 26 (Ala. 1995) (plaintiff asserted claims for fraud, breach of contract, and violations of state franchise laws); Specialized Tours, Inc. v. Hagen, 392 N.W.2d 520, 524 (Minn. 1986) (plaintiff asserted claims for breach of contract, breach of warranty, fraud, misrepresentation, and state securities violations). If the transaction involves businesses in a highly regulated

and mergers.[166] This article, however, focuses on claims for fraud,

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industry, such as banking, insurance, health care, certain franchises, etc., there may be additional claims that can be asserted based on those industries' enabling and regulatory statutes.

Even a cursory discussion of securities law claims would be far too lengthy to discuss herein. However, it is important to note that the federal securities laws will be implicated even if 100% of a corporation's stock is being purchased. This has been the case since the United States Supreme Court in Landreth Timber Co. v. Landreth, 471 U.S. 681, 693-97 (1985), and Gould v. Ruefenacht, 471 U.S. 701 (1985), rejected the "sale of business doctrine," a doctrine which had held that securities laws are inapplicable to the sale of corporate business when the purchaser acquires 100% of the stock.

However, as a result of recent reforms in the federal securities laws by the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (1995), it has become increasingly more difficult for stockholders to obtain relief in the federal courts for injuries suffered as a result of wrongful conduct. Accordingly, the availability of redress under state law is becoming more and more important to stockholders seeking such relief. *See generally* John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335 (1996) (providing an overview of these reforms and the history behind them).

With regard to racketeering claims, prior to passage of the PSLRA, stockholders could not, as a general rule, bring an action under the federal Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1962 (1991), "in their individual capacity to redress injuries inflicted upon their corporation." *Sound Video*, 700 F. Supp. at 136 (citing Rand v. Anaconda-Ericcson, Inc., 794 F.2d 843, 849 (2d Cir.), *cert. denied*, 479 U.S. 987 (1986); Warren v. Manufacturers Nat'l Bank, 759 F.2d 542, 544 (6th Cir. 1985); Nordberg v. Lord, Day & Lord, 107 F.R.D. 692, 699 (S.D.N.Y. 1985)). "This is so even when the plaintiff is the sole stockholder of the injured corporation." *Id. See also* Green v. Victor Talking Mach. Co., 24 F.2d 378, 380 (2d Cir.) ("Even when all the stock is owned by a sole shareholder, there seems no adequate reason to depart from the general rule that the corporation and its shareholders are to be treated as distinct legal persons."), *cert. denied*, 278 U.S. 602 (1928); Sirinakis v. Colonial Bank, 600 F. Supp. 946, 953 n.10 (S.D.N.Y. 1984) (president and principal shareholder of shipping company could not claim companies tort and contract damages as his own).

"An exception to the general rule exists when the injury creates not only a cause of action in favor of the corporation but also a cause of action in favor of a shareholder, as an individual, for violation of a duty owed directly to him." *Sound Video*, 700 F. Supp. at 136-37; *see also* Henry v. Gen. Motors Corp., 236 F. Supp. 854, 857 (N.D.N.Y.), *aff'd*, 339 F.2d 887 (2d Cir. 1964); General Rubber Co. v. Benedict, 109 N.E. 96 (N.Y. 1915) (stating breach of duty of good faith owed by director to plaintiff makes out a cause of action). However, as part of the PSLRA, "Congress amended RICO to remove securities fraud claims as RICO predicate acts." ABF Capital Management v. Askin Capital Management, L.P., No. 96CIV2978 (RWS), 1997 Dist. LEXIS 621, at *20 (S.D.N.Y. Jan. 22, 1997).

[166]In his recent book, Blank Rome Comisky & McCauley attorney Frederick D. Lipman presents a comprehensive analysis of how to value a business along with a step-by-step guide on how to achieve maximum value for anyone contemplating the sale of their business. FREDERICK D. LIPMAN, HOW MUCH IS YOUR BUSINESS WORTH? (1996). Recently, practitioners have begun recommending an "earnout" to close a deal. Harvey L. Pitt & Stephen I. Glover, *Mergers and Acquisitions*, NAT'L L.J., Jan. 27, 1997, at B5. An "earnout" is an agreement by which "a portion of the purchase price [of a business] is contingent on achievement of financial

misrepresentation, breach of contract, and breach of warranty arising out of the value placed on the target business, arising out of misdisclosures or nondisclosures[167] involving issues of value.[168]

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or other performance targets after the deal closes." *Id.*

[167]As previously indicated, this discussion, of course, excludes securities claims that can be brought.

[168]Depending upon the terms of the particular merger agreement, claims arising out of acquisitions or business combinations may be subject to mandatory arbitration. *See, e.g., Delta Holdings*, 945 F.2d at 1239 (agreement required certain claims to be arbitrated).

In certain transactions, the importance of direct claims for fraud, misrepresentation, breach of contract, and breach of warranty are highlighted by the fact that a new owner or new majority stockholder who later discovers claims for breach of fiduciary duty arising out of actions taken by the previous management may be precluded by the "Bangor Punta Doctrine" from asserting those claims on behalf of the corporation due to a lack of standing. In summary, the Bangor Punta Doctrine is an equitable doctrine that denies stockholders the right to seek damages from former directors for corporate mismanagement. Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R., 417 U.S. 703 (1974) (developing the "Bangor Punta Doctrine"). In this case, Bangor Punta Operations (BPO), a wholly-owned subsidiary of Bangor Punta Corp. (Bangor Punta), purchased 98.3% of the stock of Bangor & Aroostook Railroad Company (BAR). *Id.* at 705. Thereafter, BPO sold BAR stock to Amoskeag Corporation, which later increased its interest to 99%. *Id.* at 706. Two years later, Amoskeag caused BAR to sue Bangor Punta and BPO for acts of mismanagement, including federal antitrust and security violations, allegedly committed by Bangor Punta while it controlled and operated BAR. *Id.* The United States Supreme Court held that the action could not be maintained because the real party in interest and beneficiary of any recovery was Amoskeag. *Id.* at 711. However, Amoskeag would have had no standing to sue Bangor Punta because: (1) it suffered no injury from the alleged wrong since it was not a stockholder of BAR at the time of the wrong, (2) it had received full value for its purchase price, and (3) any recovery by Amoskeag would be a windfall because it would be retaining its shares while recovering its purchase price. *Id.* at 711-18. The Bangor Punta Doctrine was based upon a rationale first articulated almost 100 years ago. *See* Home Fire Ins. Co. v. Barber, 93 N.W. 1024, 1031 (Neb. 1903) ("To permit [the stockholders] to recover . . . would be highly inequitable."). *See also* Atlantis Plastics Corp. v. Sammons, No. 930, 1988 Del. Ch. LEXIS 44, at *8 (Del. Ch. Mar. 30, 1988), *reprinted in* 13 DEL. J. CORP. L. 1090, 1096 (1988) (holding that because none of the present stockholders owned any shares of the corporation at the time of the misconduct, they could not bring an action for breach of fiduciary duty against former directors for that misconduct); Council of South Bethany v. Sandpiper Dev. Corp., No. CIV.A.935, 1986 WL 10081, at *5 (Del. Ch. Sept. 4, 1986) (applying Bangor Punta Doctrine); Courtland Manor, Inc. v. Leeds, 347 A.2d 144, 147 (Del. Ch. 1975) (applying *Bangor Punta* rationale to bar direct corporate suit against former mismanagement for alleged prior wrongdoing). There are, of course, exceptions to the Bangor Punta Doctrine, such as the "minority stockholder exception" and the "creditor exception." *Bangor Punta Operations*, 417 U.S. at 721-26. *See also* Federal Sav. & Loan Ins. Corp. v. Reeves, 816 F.2d 130, 133 (4th Cir. 1987) (distinguishing *Bangor Punta* because the "loss" suffered by plaintiffs was part of the consideration of a prior merger); Meyers v. Moody, 693 F.2d 1196, 1207 (5th Cir. 1982) (distinguishing *Bangor Punta* because the principal beneficiaries of any recovery would be the creditors, not the shareholders), *cert. denied*, 464 U.S. 920 (1983); Courtland Manor, Inc. v. Leeds, 347 A.2d 144, 147 (Del. Ch. 1975) (applying *Bangor Punta* rationale to bar direct corporate suit against former mismanagement for alleged prior wrongdoing); Federal Deposit Ins. Corp. v. Benson, 867 F.

Claims for fraud, misrepresentation, breach of contract,[169]

Supp. 512, 524 (S.D. Tex. 1994) (distinguishing *Bangor Punta*, as allowing plaintiffs to pursue their claim would not result in unjust enrichment); Federal Sav. & Loan Ins. Corp. v. Williams, 662 F. Supp. 132, 134 (D. Md. 1985) (recognizing that the Bangor Punta Doctrine is inapplicable where principal beneficiaries of any recovery would be corporation creditors and not stockholders). An exception may also be recognized in the context of a potential merger. Lewis v. Anderson, 477 A.2d 1040, 1050-51 (Del. 1984).

[169]Breach of contract claims by purchasers, sellers, and third-parties not subject to discussion by this article can also take many forms and can be based on many different factual scenarios when they arise out of mergers and acquisitions. Again, the precise terminology of the claims generally depends on the nuances of state law. These claims can include requests for rescission or specific performance and allegations of failure to negotiate and/or perform in good faith, such as a failure to use best efforts to obtain regulatory approval required for a merger. *See, e.g.*, Gilbert v. El Paso Co., 575 A.2d 1131, 1133 (Del. 1990) (plaintiffs claimed defendants improperly destroyed inchoate proration rights, improperly negotiated a settlement agreement in breach of their fiduciary duties, and knowingly breached a contractual obligation to complete a tender offer); Itek Corp. v. Chicago Aerial Indus., Inc., 248 A.2d 625, 628 (Del. 1968) (plaintiff claimed defendant breached a merger contract by willfully refusing to negotiate in good faith towards completion of the deal); VS&A Communications Partners, L.P. v. Palmers Broad. Ltd. Partnership, No. 12,521, 1992 Del. Ch. LEXIS 136, at *1 (Del. Ch. July 14, 1992) (plaintiff sought order compelling defendants to negotiate in good faith); Carteret Bancorp, Inc. v. Home Group, Inc., Nos. 9380 & 9386, 1988 Del. Ch. LEXIS 2, at *1 (Del. Ch. Jan. 13, 1988) (plaintiffs claimed breach of contractual undertaking to use best efforts and act in good faith). In conjunction with these breach of contract claims can be claims for tortious interference with contractual relations, tortious interference with prospective business advantage, breach of confidentiality clauses in merger agreements, allegations of use of trade secrets acquired during negotiations, and claims of unfair competition. *See, e.g.*, Sip-Top, Inc. v. Ekco Group, Inc., 86 F.3d 827, 829-30 (8th Cir. 1996); *VS&A Communications*, 1992 Del. Ch. LEXIS 136, at *1 (negligent misrepresentation). Similarly, claims can be brought by players in the transactions for breach of contract arising out of failure to pay finders fees or acquisition fees, coupled with a claim of unjust enrichment or quantum meruit. *See, e.g.*, Positive Communications, Inc. v. LePerq, de Neuflize & Co., No. C-95-2463 SC, 1996 U.S. Dist. LEXIS 13530, at *1 (N.D. Cal. Sept. 10, 1996) (breach of contract and unjust enrichment); Papendick v. Bosch, 410 A.2d 148, 148 (Del. 1979) (breach of contract to recover finder's fee), *cert. denied*, 446 U.S. 909 (1980).

For the most part, general contract principles will apply to contract claims arising out of mergers and acquisitions. However, some points warrant a brief discussion. First, contractual rights may have to give way to the fiduciary duties or court imposed duties officers and directors owe to a corporation and its stockholders. For example, if the sale of a company has become inevitable, directors may be obligated to breach a previously signed merger agreement in order to meet its obligation to obtain the best possible price for the corporation's stockholders. *Paramount*, 637 A.2d at 51. In *Paramount*, the Delaware Supreme Court held that directors cannot contract away their fiduciary duties. *Id.* at 39, 51. The court declared unreasonable a provision of a merger agreement, whereby the board of the selling corporation agreed that it would not solicit, encourage, discuss, negotiate, or endorse any competing transaction unless certain conditions were met because the provision was inconsistent with the directors' fiduciary duties. *Id.* The court also noted that any contract, or provision thereof, which purports to require a board to act or not act in such a fashion as to limit the exercise of their fiduciary duties is invalid and unenforceable. *Id.* at 51. Second, in connection with a

and breach of warranty involving valuation issues are governed by the applicable state law,[170] and generally boil down to the purchasers arguing

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tender offer, the offeror has wide latitude over the terms of the offer and is free to engraft any number of conditions qualifying the obligation to perform. Gilbert v. El Paso Co., 575 A.2d 1131, 1142 (Del. 1990). These conditions are subject only to Securities and Exchange Commission limitations and the requirements established under the Williams Act. *Id.* (citations omitted). Third, a hostile tender offeror owes no direct fiduciary duty to the stockholders of a target company, including stockholders who tender their shares in response to the initial offer. *Id.* at 1148. Fourth, ratifications signed by principal stockholders of corporation A, whereby they agreed to vote acceptance of an offer by corporation B to purchase A's assets and assume its liabilities in a corporate merger arrangement, constitute a promise that runs to corporation A, not to corporation B. Stockholders of A cannot be held liable to B for breach of a promise when they subsequently sell their stock to a third party at a higher price. *Itek Corp.*, 248 A.2d at 630-31. If, however, corporation A is later found to be liable to corporation B, B may be able to proceed against A's stockholders on the theory that a ratification constitutes a stockholder's agreement with corporation B. *Id.* at 631. Fifth, it is well-established law that claims by preferred stockholders are, in general, purely contractual in nature and are governed by the express provisions of the corporation's certificate of incorporation and the stock's certificate of designation. Rothschild Int'l Corp. v. Liggett Group, Inc., 474 A.2d 133, 136 (Del. 1984). *See also* Baron v. Allied Artists Pictures Corp., 337 A.2d 653, 657 (Del. Ch. 1975) (stating "the rights of preferred stockholders are contract rights"); Giammalvo v. Sunshine Mining Co., No. 12,842, 1994 Del. Ch. LEXIS 6, at *11 (Del. Ch. Jan. 31, 1994), *reprinted in* 19 DEL. J. CORP. L. 1203, 1211 (1994) (stating that "[i]t is settled law that charter provisions . . . are viewed as a contract and must be interpreted accordingly"), *aff'd*, 651 A.2d 787 (Del. 1994) (citing Waggoner v. Laster, 581 A.2d 1127, 1134 (Del. 1990)). The rights of preferred stockholders are thus "fixed by the contractual terms agreed upon when the class of preferred stock is created." Wood v. Coastal States Gas Corp., 401 A.2d 932, 937 (Del. 1979) (citing Judah v. Delaware Trust Co., 378 A.2d 624, 628 (Del. 1977); Ellingwood v. Wolf's Head Oil Refining Co., 38 A.2d 743, 747 (Del. 1944); Holland v. National Automotive Fibres, 194 A. 124, 126 (Del. Ch. 1937)). *See also Waggoner*, 581 A.2d at 1134 (general rules of contract interpretation apply to instrument governing preferred stock) (citing Rothschild Int'l Corp. v. Ligget Corp., 474 A.2d 133, 136 (Del. 1984); *Wood*, 401 A.2d at 937).

[170]The applicable legal standards will vary somewhat state by state. For example, in order to succeed on a claim for fraudulent misrepresentation under Alabama law, plaintiffs must show a "(1) misrepresentation of material fact (2) concerning a material existing fact, which was (3) relied on by the plaintiffs (4) to their detriment." *Sperau*, 674 So. 2d at 33 (citing ALA. CODE § 6-5-101 (1975); Crowder v. Memory Hill Gardens, Inc., 516 So. 2d 602 (Ala. 1987)).

To support a claim alleging suppression of a material fact under Alabama law, the plaintiff must offer substantial evidence (1) that the defendant suppressed a material fact (2) that the defendant had a duty to communicate (3) either because of a confidential relationship between the parties, "or because of the particular circumstances of the case." *Crowder*, 516 So. 2d at 604 (citing ALA. CODE § 6-5-102 (1975); Boswell v. Liberty Nat'l Life Ins. Co., 643 So. 2d 580, 581 (Ala. 1994); Interstate Truck Leasing, Inc. v. Bender, 608 So. 2d 716, 718-19 (Ala. 1992)).

The elements of fraudulent misrepresentation under Maryland law are:

> (1) that the defendant made a false representation to the plaintiff, (2) that its falsity was either known to the defendant or that the representation was made

> with reckless indifference as to its truth, (3) that the misrepresentation was made for the purpose of defrauding the plaintiff, (4) that the plaintiff relied on the misrepresentation and had the right to rely on it, and (5) that the plaintiff suffered compensable injury resulting from the misrepresentation.

Ellerin v. Fairfax Sav., F.S.B., 652 A.2d 1117, 1123 (Md. 1995) (citations omitted). Similarly, a claim for fraud under Minnesota law requires a plaintiff to prove that

> (1) there was a false representation by a party of a past or existing material fact susceptible of knowledge; (2) made with knowledge of the falsity of the representation or made as of the party's own knowledge without knowing whether it was true or false; (3) with the intention to induce another to act in reliance thereon; (4) that the representation caused the other party to act in reliance thereon; and (5) that the party suffer pecuniary damage as a result of the reliance.

Specialized Tours, 392 N.W.2d at 532 (citing Burns v. Valene, 214 N.W.2d 686, 689 (Minn. 1974); Davis v. Re-Trac Mfg. Corp., 149 N.W.2d 37 (Minn. 1967)).

On the other hand, to succeed on claims for breach of contract and breach of warranty a plaintiff must simply prove that the defendant, "in violation of the warranties contained in the purchase and sales agreement, made misrepresentations or omissions of material facts." B.S. Int'l Ltd. v. Licht, 696 F. Supp. 813, 827 (D.R.I. 1988). These types of claims are much less dependent on the applicable state law and are generally governed by the express terms of the warranties made in the contract for the sale of a company. *See, e.g., In re* Public Investors, Inc. v. Finevest Life Investors Ltd. Partnership, 998 F.2d 284, 287 (5th Cir. 1993) (holding that in a sale of all outstanding stock of a corporation, "[a] warranty relating to the taxability of returns on certain investments held by its subsidiary is not a warranty on 'the thing sold' or on a physical object to which the right may ultimately relate"; therefore, the warranties did not give rise to redhibition); Metromedia Co. v. Fugazy, 983 F.2d 350, 360 (2d Cir. 1992) (holding that under New York law, a breach of warranty claim was governed by an inclusion in a purchase agreement that certain representations and warranties were part of the bargain), *cert. denied*, 508 U.S. 952 (1993); Galli v. Metz, 973 F.2d 145, 148 (2d Cir. 1992) (holding that a clause contained in a stock purchase agreement which warranted that a corporation had "no claims, legal actions, suits, arbitrations, governmental investigations in progress or pending," shifted the risk of an unknown tax claim from buyers to sellers); Hendricks v. Callahan, 972 F.2d 190, 196 (8th Cir. 1992) (holding there was no breach of property warranty where warranty did not promise clear title to the leasehold); *Delta Holdings*, 945 F.2d at 1242-43 (holding actuarial firm's report concerning reinsurance corporation's loss reserve was not material at the time of purchase, so as to impose a duty on the corporation's president under a warranty in the stock purchase agreement to disclose the report, because the accounting method used in the report was generally known by the accounting firm), *cert. denied*, 503 U.S. 985 (1992); Wickoff v. Vanderveld, 897 F.2d 232, 240 (7th Cir. 1990) (holding warranties contained in a stock purchase agreement were clearly indicative of the parties' intent that the seller would warrant accuracy and completeness of the company's financial statements); TBG, Inc. v. Bendis, 845 F. Supp. 1459, 1461 (D. Kan. 1994) (holding that under New York law, a provision in a stock purchase agreement limiting the liability of sellers "may not be avoided on the grounds of fraud in the inducement"), *aff'd*, 36 F.3d 916 (10th Cir. 1994); Keenan v. D.H. Blair & Co., 838 F. Supp. 82, 90 (S.D.N.Y. 1993) (holding that "express warranty arises when a seller [of stock] directly affirms the quality or condition of the stock, provided that such affirmation tends to induce the buyer's purchase, and the buyer purchases relying upon it"); Professional Serv. Indus., Inc. v. Kimbrell, 834 F. Supp. 1305, 1311-12 (D. Kan. 1993) (holding that a seller of stock in asbestos corporations was not liable for breach of an express warranty in a stock purchase agreement, where the buyer was a sophisticated purchaser); Plasti-

that they did not get what they bargained for due to misdisclosures, nondisclosures, or, in the purchasers' view, an improper valuation of the business.[171] For example, in *Sperau v. Ford Motor Co.*,[172] the plaintiffs purchased a Ford Motor Company (Ford) dealership relying upon representations by Ford personnel that the sales, profit forecasts, and capitalization requirements provided to them were reasonable.[173] The plaintiffs were African-Americans to whom Ford personnel represented that projected returns on the plaintiffs' investment would be as high as 65.4% when the Ford personnel knew, based on yearly Equal Opportunity Progress Reports to Ford's Board of Directors, that minority dealers, like plaintiffs, were predicted to lose money.[174] The plaintiffs' dealership failed and later filed for bankruptcy, causing the plaintiffs to lose their total investment of approximately $992,000.[175] The Alabama Supreme Court affirmed[176] a jury's decision to hold Ford liable for fraudulent misrepresentation and award $10,492,000, including $6 million in punitive damages, which was later remitted to $7,692,000.[177]

Similarly, in *VF Corp. v. Wrexham Aviation Corp.*,[178] VF Corporation sold one of its subsidiaries, Wrangler Aviation Corporation (Wrangler), to Wrexham Aviation Corporation (Wrexham).[179] The purchase agreement contained the following provisions:

> 9.(h) Attached hereto as Schedule 9(h) is a copy of the Company's financial statements for the fiscal year ended June 30, 1990, which were audited by KPMG/Peat Marwick. To the best of Seller's knowledge, such financial statements, including any qualifications set forth therein, fairly present

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Line Mfg. Co. v. Combined Communications Corp., 741 F. Supp. 141, 143 (E.D. Tenn. 1989) (holding that breach of a provision contained in a purchase agreement was material where the buyer "was forced to make a purchase decision without a second 'due diligence' investigation and without audited financial records" of the company it was purchasing), *aff'd without op.*, 917 F.2d 1304 (6th Cir. 1990).

[171]Interestingly, in Willco Kuwait v. DeSavary, 638 F. Supp. 846 (D.R.I. 1986), *aff'd in part, remanded in part*, 843 F.2d 618 (1st Cir. 1988), the court held that for the purposes of establishing ownership at the time of trial, the seller of a 50% interest was only required to deliver title to 50% of the stock to the buyer at the time of sale — he was not required to have title to all the stock when the contract was entered into. *Id.* at 855.

[172]674 So. 2d 24 (Ala. 1995).

[173]*Id.* at 27.

[174]*Id.* at 28-31.

[175]*Id.* at 31-32.

[176]*Sperau*, 674 So. 2d at 42.

[177]*Id.* at 27-28.

[178]No. 1700, 1996 Md. App. LEXIS 157 (Md. Ct. Spec. App. Nov. 27, 1996).

[179]*Id.* at *4-5.

> the Company's financial condition and results of operation for the Company's fiscal year ended June 30, 1990. . . .
>
> . . . .
>
> 13.(a) There shall not be any material error, misstatement or omission in the representations and warranties made by the Seller in this Agreement; all representations and warranties by the Seller contained in this Agreement shall be true in all material respects at and as of the Closing as though such representations and warranties were made at and as of said date; . . . .[180]

The closing was scheduled to take place over a two-day period and the closing certificate contained the following provision:

> The Seller hereby certifies that all of the representations and warranties with respect to the Seller contained in the Purchase Agreement are true, accurate and complete in all material respects on and as of the date hereof. The delivery of this Certificate in no way expands, diminishes or supersedes the warranties and representations of the Seller contained in the Purchase Agreement.[181]

Unbeknownst to Wrexham, on the first day of closing, Wrangler's comptroller was presented with a field audit report in which the North Carolina Department of Revenue asserted that Wrangler owed $372,199.45 in sales and use taxes and that a refund claim of $107,000 would no longer be available.[182] This information was conveyed to VF Corporation's treasurer, who was handling the sale.[183] Despite the

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[180] *Id.* at *5-6. The purchase agreement also contained the following standard limitation on the warranty provisions:

> 16. . . . In connection with the Buyer's due diligence examination of the Business of the Company, the Buyer has not relied upon any statement, opinion, representation, or warranty of the Seller VF, or either of their respective directors, officers, employees, agents, or representatives, express or implied, other than those representations and warranties of the Seller expressly set forth in Section 9 hereof or elsewhere in this Agreement.

Id. at *6.

[181] *Id.* at *7.

[182] *VF Corp.*, 1996 Md. App. LEXIS 157, at *7.

[183] *Id.* at *8.

following additional provision in the closing certificate, VF Corporation's treasurer never disclosed this information to Wrexham:

> to the best of Seller's knowledge, such financial statements, including any qualifications set forth in the accountant's opinion and the accompanying footnotes set forth therein, fairly present the Company's financial condition and results of operation for the fiscal year ended June 30, 1990.[184]

Upon acquiring Wrangler and discovering the undisclosed tax liability, Wrexham filed suit against VF Corporation for fraud, breach of contract, and breach of warranty. A jury returned a verdict in favor of Wrexham for $189,336.61 in compensatory damages and $21.4 million in punitive damages.[185] The Court of Special Appeals of Maryland upheld the compensatory damages award, but remanded the case for further proceeding to determine whether the punitive damages award satisfied the Due Process Clause of the United States Constitution.[186]

An example of a dispute over the methodology used to prepare financial statements is the Minnesota Supreme Court's decision in *Specialized Tours, Inc. v. Hagen*,[187] in which Specialized Tours, Inc. (Specialized) purchased Dittmann Travel Organization, Inc.[188] (Dittmann) and later brought suit alleging, among other things, that the financial statements provided to Specialized did not accurately reflect the net worth of Dittmann.[189] Dittmann warranted the accuracy of the financial statements and it was "undisputed that the statements accurately represented the financial condition of Dittmann according to the accounting method Dittmann had always used," a method traditionally used by the company that was recognized by the Internal Revenue Service.[190] The basis of Specialized's claim was that Dittmann's balance sheet recognized income and expenses under an accounting method not in accordance with generally accepted accounting principles, which significantly overvalued the company.[191] The trial court had accepted

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[184] *Id.* at *8-9.

[185] *Id.* at *1-2. The jury also returned a verdict of $535,000.00 in compensatory damages against Wrangler Apparel Corporation, another subsidiary of VF Corporation which was involved in negotiating the sale of Wrangler. *Id.* at *2.

[186] *VF Corp.*, 1996 Md. App. LEXIS 157, at *49.

[187] 392 N.W.2d 520 (Minn. 1986).

[188] *Id.* at 524.

[189] *Id.* at 529.

[190] *Id.* at 530.

[191] *Specialized Tours*, 392 N.W.2d at 530.