**Key Delaware Decisions**

**Relative Fairness** - *Levco Alternative Fund Ltd. v. The Reader’s Digest Association, Inc.*, 803 A.2d 428 (Del. 2002).

On August 13, 2002, the Delaware Supreme Court considered an appeal by non-voting stockholders of The Reader’s Digest Association, Inc. (“RCA”), who sought to prevent the implementation of a recapitalization of RDA.

The recapitalization plan called for RDA (among other things) to recapitalize each share of its Class A Nonvoting Common Stock (“Class A Stock”) into one share of Common Stock (“Common Stock”) and to purchase from The DeWitt Wallace-Reader’s Digest Fund and the Lila Wallace-Reader’s Digest Fund (collectively, the “Funds”), 3,636,363 shares of Class B Voting Common Stock (“Class B Stock”) for approximately $100,000,000 in cash. The Funds’ block of Class B Stock represented 50% of all the Class B Stock. Following the recapitalization, the Funds would hold fourteen percent of the Common Stock, the sole remaining class of RDA capital stock.

The company planned to effect the recapitalization either by merging a wholly-owned subsidiary into RDA or, in the event that the holders of $5,000,000 in stated value of RDA preferred stock exercised appraisal rights in the merger, by amending RDA’s certificate of incorporation. Since the Funds had agreed to vote in favor of the proposed recapitalization, stockholder approval was a foregone conclusion.

Because two directors of RDA were also directors of the Funds, the RDA board of directors appointed a special committee. The committee members, according to RDA’s proxy statement, were “to act as disinterested negotiators on behalf of the company and to negotiate, review and, if appropriate, recommend the recapitalization to the entire board of directors of the company.” The special committee was not, however, charged with representing, or even taking into account, the separate interests of the holders of the Class A and Class B Stock, respectively. The special committee negotiated with the Funds on behalf of RDA and eventually recommended the form of recapitalization described above.

Goldman, Sachs & Co. (“Goldman”), the financial advisor to the special committee, rendered a fairness opinion. RDA’s proxy statement described Goldman’s opinion as stating that the repurchase of 3,636,363 shares of Class B Stock from the Funds for approximately $100,000,000 and the recapitalization ratios of 1.24 shares of Common Stock per share of Class B Stock (other than the Class B Stock repurchased from the Funds) and one share of Common Stock per share of Class A Stock, “taken as a whole, pursuant to the recapitalization agreement, was fair from a financial point of view to the holders of Class A Nonvoting Common Stock and Class B Voting Common Stock (other than the Funds)”. The Goldman opinion stated explicitly, however, that Goldman expressed no view “as to the relative fairness of the Recapitalization to the holders of Class A Common Stock as compared to the holders of Class B Common Stock.”

Holders of Class A Stock sought to enjoin the recapitalization arguing that the RDA directors, including the special committee, were subject to the control of the Funds and thus were required to demonstrate the entire fairness of the transaction. The Court of Chancery denied the injunction ruling that, regardless of who had the burden of proof, the evidence did not indicate that the plaintiffs would ultimately demonstrate that the activities of the special committee did not result in a fair and genuinely negotiated price.

The Supreme Court reversed, rejecting the defendants’ argument that the directors discharged their fiduciary duty to the Class A stockholders through the intensive negotiations between the Funds and the special committee. In reaching its conclusion, the Supreme Court offered several noteworthy remarks. First, the Court observed that the special committee had not sought, and Goldman did not tender, an opinion as to whether the transaction was fair to the Class A stockholders. Second, the Court noted that, in light of the “obvious conflicting interests of the shareholder classes,” the absence of “an evaluation of the fairness of the recapitalization on the Class A shareholders is significant.” Finally, the Court remarked that “to the extent that the directors did not secure sufficient information concerning the effect of the recapitalization premium on the Class A shareholders, a serious question is raised concerning the discharge of their duty of care.” In light of these deficiencies, the Supreme Court held that the plaintiffs’ claim with respect to entire fairness had a reasonable probability of success.

Several important takeaways may be gleaned from *Reader’s Digest*:

* **Relative Fairness Matters.** Given the constraints of time, the Supreme Court’s opinion was necessarily brief. Nevertheless, the opinion clearly articulates one key concern – the failure of a financial advisor’s fairness opinion to address the relative fairness of a transaction that impacts the holders of separate classes of stock differently may render the process irreparably flawed.
* **But Questions Remain…** The Court’s opinion notes that the “Special Committee *never sought*, nor did its financial advisor...ever tender” a fairness opinion addressing the relative fairness of the transaction (emphasis added). If the Special Committee had focused on the specific impact that the transaction would have had on the holders of the Class A Stock and if the Special Committee had requested a “relative fairness” opinion, then the Court may not have deemed the Special Committee’s subsequent failure to obtain such an opinion from its financial advisor as a fatal mistake.

**Relative Fairness and Contingent Fees** - *In re Tele-Communications, Inc. Shareholders Litig.*, C.A. No. 16470, Chandler, C. (Del. Ch. Dec. 21, 2005).

On December 21, 2005, the Court of Chancery rendered a decision in *In re Tele-Communications*, denying defendants' motion for summary judgment on several claims arising out of the merger of Tele-Communications, Inc. with AT&T Corp. In the course of the opinion, the Court commented on two issues of note concerning financial advisors: first, the importance of obtaining a fairness opinion addressing the relative fairness of the allocation of merger consideration in a high vote/low vote stock structure; and second, the manner in which a contingent fee structure will factor into the Court’s analysis when evaluating of the effectiveness of the special committee process.

At issue in *TCI* was the treatment of two series of common stock: Series A TCI Group Common Stock (the "Series A shares") and Series B TCI Group Common Stock (the "Series B shares"). The Series A shares were entitled to one vote per share, while the Series B shares were entitled to ten votes per share. In all other respects, the Series A shares and the Series B shares were identical. When TCI and AT&T began discussing a possible merger, John Malone, TCI's Chairman and Chief Executive Officer, insisted that the Series B shares would have to receive a premium of ten percent over the Series A shares in order to obtain his consent and approval of the transaction as a TCI stockholder. While Malone alone owned a majority of the Series B shares (and controlled 47% of the total voting power of the TCI shares), Malone and four other TCI directors, who collectively constituting a majority of the nine member TCI Board, owned 84% of all of the outstanding Series B shares (and a majority of the total voting power of the TCI shares).

The TCI Board formed a special committee to consider the proposed merger. The special committee was comprised of two members: Paul A. Gould, an owner of significantly more Series B shares than Series A shares, and John W. Gallivan. The special committee, which met four times over a five day period, relied on TCI's financial and legal advisors. TCI's financial advisor informed the special committee of precedent transactions where high-vote stock had received a premium to low-vote stock, but noted that those transactions were "less common" than transactions where no premium was paid. TCI's financial advisor also opined on the fairness of the merger consideration to each of the Series A shares and the Series B shares, respectively.

After receiving that advice, the special committee recommended the merger to the full TCI Board and it was approved. Several months later, TCI stockholders overwhelmingly approved the merger. As a result of their ownership of the Series B shares, a majority of the directors received, in the aggregate, $376 million more than they would have received if no premium had been paid and the shares were treated equally. Malone obtained the highest benefit from the premium, receiving in excess of $100 million more than he would have received if there were no premium, while the director obtaining the lowest benefit from the premium received in excess of $500,000 more than he would have received if there were no premium.

Plaintiff stockholders brought several claims challenging the merger. In rejecting defendants' motion for summary judgment on certain of those claims, the Court concluded, among other things, that the relevant standard of review was entire fairness. Citing *Reader's Digest*, the Court found that entire fairness should apply because "a clear and significant benefit . . . accrued primarily . . . to [] directors controlling [] a large vote of the corporation, at the expense of another class of shareholders to whom was owed a fiduciary duty." In the alternative, the Court concluded that a majority of the TCI directors were interested in the transaction because they each received a material benefit from the Series B shares premium.

After concluding that the transaction would be reviewed under the entire fairness standard, the Chancellor concluded that, based on the current record, the defendants had failed to demonstrate that the merger was entirely fair because genuine issues of material fact remained relating to fair dealing and fair price. Accordingly, the Chancellor denied defendants' motion for summary judgment. In reaching the decision that the defendants failed to demonstrate fair dealing and fair price, the Court found, based on a review of the evidence in a light most favorable to the plaintiffs, a number of process flaws, including several relating to the special committee and the role of its financial advisor:

* **The Special Committee’s Interest.** The Court criticized the contingent nature of the fee paid to the financial advisor, which amounted to approximately $40 million, finding that such a fee created "a serious issue of material fact, as to whether [the financial advisor] could provide independent advice to the Special Committee." The Court added that while TCI (and Malone) may have had no interest in paying such compensation absent a deal, "[a] special committee does have an interest in bearing the upfront cost of an independent and objective financial advisor." Put another way, when a special committee is considering whether to recommend a transaction (or exercise its “power to say no”), it generally will have an “interest” in making sure that its financial advisor does not have a financial incentive to always say “yes” (in the form of a favorable fairness opinion).
* **The Fairness Opinion.** In the *TCI* decision, the Court found the financial advisor’s research to be deficient in several respects and concluded that, as a result, the special committee was not fully informed on several key financial issues (despite the delivery of a written fairness opinion). Specifically, the Court questioned the financial advisor’s analysis on two grounds - the failure to provide complete information on the premium at which the Series B shares historically traded and the failure to adequately inform the Special Committee with respect to the relative prevalence of high-vote transactions in which the high-vote stock received no premium.
* **Absence of a “Relative Fairness” Analysis.** In *TCI*, the Chancellor also focused on the nature of the fairness opinion delivered by the financial advisor. While the financial advisor did conduct a separate analysis of the fairness of the price to be paid to each class, the financial advisor's opinion did not "discuss the effect of the [Series B shares] premium upon the [Series A] holders, *i.e.*, whether the [] premium was fair to the [Series A] holders." The Court stated that the *Reader's Digest* decision "appears to mandate exactly such an analysis: that the relative impact of a preference to one class be fair to the other class." The Court noted that the *Reader's Digest* decision "mandated more than separate analyses that blindly ignore the preferences another class might be receiving, and with good intuitive reason: such a doctrine of separate analyses would have allowed a fairness opinion in our case even if the [Series B] holders enjoyed a 110% premium over the [Series A] holders, as long as the [Series A] holders enjoyed a thirty-seven percent premium over the market price."
* **When All Else Fails, Build the Record.** After *TCI*, a special committee that is considering a high-vote stock premium transaction will be expected to have requested a fairness opinion that evaluates not only the fairness of the merger consideration to each class or series separately, but also the relative fairness of the merger consideration to the low-vote stock in light of any premium paid on the high-vote stock. Unfortunately, few financial advisors will agree to provide such an opinion. For that reason, when selecting a financial advisor, a special committee should inquire as to whether the advisor will be able to render such an opinion. If the special committee is unable to engage a financial advisor who will provide such an opinion, then the special committee should work with the financial advisor it selects to establish a record that demonstrates that the special committee considered any analysis (short of a fairness opinion) that could be prepared concerning the relative fairness of the transaction.

**Relative Fairness Redux** - *In re Toys “R” Us, Inc. Shareholder Litig.*, 877 A.2d 975 (Del. Ch. 2005).

In *Toys “R” Us*, the Court considered claims arising from a proposed merger involving Toys “R” Us, Inc. (“Toys “R” Us”) and an acquisition vehicle formed by a group led by Kohlberg Kravis Roberts & Co. (the “KKR Group”). The merger was the result of a search by Toys “R” Us for strategic alternatives following a dismal holiday season in December 2003. On January 8, 2004, the Chief Executive Officer confirmed in a call to analysts that the company likely would consider strategic options. Thereafter, the board of directors, consisting of nine independent directors and the Chief Executive Officer, met to consider embarking on a process to search for strategic alternatives and hired financial and legal advisors to assist them in that process.

Ultimately, after a protracted sales process, the board accepted a bid from the KKR Group. Plaintiff stockholders brought suit seeking a preliminary injunction against the closing of the merger. The Court, concluding that the plaintiffs were unlikely to prevail on their claims, refused to grant the preliminary injunction.

At its core, the plaintiffs’ request for relief was based on the claim that the directors did not fulfill their *Revlon* duties. The Court noted that this case did not present the “paradigmatic context for a good *Revlon* claim, which is when a supine board under the sway of an overweening CEO bent on a certain direction, tilts the sales process for reasons inimical to the stockholders’ desire for the best price.” Rather, the Court noted, the present case involved a “majority independent board that publicly initiated a broad search for strategic options to increase shareholder value, ruling out no option.” The plaintiffs, however, attempted to “sketch out a picture of a passive board who deferred too easily to the wishes of a CEO . . . and [its] financial advisor.” According to the plaintiffs, the CEO favored a deal that led to a sale of the entire company for self-interested reasons and the financial advisor supported the sale of the entire company because it stood to receive an additional $7 million in fees as a result of that sale.

With respect to the latter argument, the Court concluded that the financial advisor did not tilt the process in favor of the sale of the entire company in order to increase its fees. Although the financial advisor stood to earn a larger fee if the whole company was sold than if just Global Toys was sold, that fee arrangement “was designed to provide an incentive for [the financial advisor] to seek higher value.” The Court noted that such a fee arrangement “has been recognized as proper by our courts.” *See, e.g.*, *In re MONY Group Inc. S’holder Litig.*, 852 A.2d 9, 22 (Del. Ch. 2004); *accord In re Vitalink Communications Corp. S’holders Litig.*, 1991 WL 238816, at \*10 (Del Ch. Nov. 8, 1991), *aff’d sub nom.*, *Grimes v. John P. McCarthy Profit Sharing Plan*, 610 A.2d 725 (Del. 1992).

* **Reconciling *TCI* with *Toys “R” Us*.** In this case (and the other cases cited by the Court), a majority independent board initiated a strategic process that resulted in a sale of the company. In each case, once the board commenced that process, its goal was to secure a transaction with the highest value for the stockholders (without regard to the identity of the buyer). As a result, the board’s decision to provide the financial advisor with an incentive to secure the best price aligned with the best interests of the stockholders. In contrast, in conflicted merger transactions involving a controlling stockholder (such as *TCI*), the responsibility of the special committee is to protect the interests of those stockholders who are subject to the controlling stockholder’s potentially self-interested and/or oppressive conduct. In those circumstances, if a financial advisor’s fee is either contingent upon or largely tied to the successful consummation of a transaction, then that fee structure often will fail to align the financial advisor’s interests with the best interests of the stockholders.

**Fairness Opinion Bring Downs** – *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001).

In *Unocal Exploration*, minority shareholders of Unocal Exploration Corp. challenged the short-form merger of UXC into Unocal Corp., which owned 96% of UXC's stock. The special committee that negotiated the exchange ratio and recommended the transaction relied on a fairness opinion provided by PaineWebber, as well as a presentation by PaineWebber several months later. The plaintiffs argued that they did not receive a fair price for their shares and they challenged the independence of the UXC special committee that negotiated the merger. Specifically, the plaintiffs claimed that the merger price was unfair because it did not properly reflect the increase in gas prices during the first quarter of 1992, which should have caused UXC's market value (as a "pure play" company) to grow at a greater rate than its diversified parent.

The Court ruled in favor of the defendants, concluding that appraisal was the minority shareholders' only remedy. In the course of reaching its decision, however, the Court considered whether there was an obligation to obtain a bring-down opinion from an investment banker when it is alleged that the deal's fixed exchange ratio is no longer fair because of market changes after delivery of the formal fairness opinion.

The Court first observed that "[t]he evidence at trial made clear that full bring-down opinions are the exception, not the rule.” The Court added, however, that “[n]aturally, changes between the date of a fairness opinion and the date of the merger completion can be so great as to render an earlier fairness opinion unreliable." Quoting *Behrens v. United Investors Management Co.*, 1993 WL 400209 at \*12 (Del. Ch. 1993), the Court remarked that "[p]erhaps some set of intervening changes in public markets would be such as to require diligent directors to, in effect, say 'How could it be that the deal we earlier negotiated is still fair to the minority?'" Notably, however, the Court concluded that there was "no proof that the Special Committee or Unocal affirmatively closed its eyes to relevant information" and therefore the special committee was not required to obtain a bring-down of the fairness opinion.

While the Court’s decision in *Unocal Exploration* did not mandate the use of bring-down opinions, it did suggest that there may be circumstances in which a bring-down opinion would be prudent. In anticipation of such circumstances developing, boards should consider adopting the following practices:

* **Think Ahead.** When a company engages a financial advisor for a fairness opinion, it should consider addressing in the engagement letter both the company’s right to ask for a bring-down and the cost of such an opinion.
* **Understanding the Duty to Revisit and Confirm.** In *Frontier Oil Corp. v. Holly Corp.*, 2005 WL 1039027 (Del. Ch. 2005), the Court observed that “[r]evisiting the commitment to recommend” a merger is not merely a contractual right of the board to be preserved in a merger contract; rather, it is the board’s “duty … to review the transaction to confirm that a favorable recommendation [continues] to be consistent with its fiduciary duties.” When undertaking such a review, the board should (i) determine whether (and the extent to which) the circumstances have changed since the initial delivery of the fairness opinion, (ii) investigate what impact, if any, such changes have on the proposed deal; (iii) decide whether, in light of such changes, the earlier fairness opinion is unreliable and, if so, whether it is appropriate to request a bring-down opinion from the investment banker; and (iv) decide whether it is appropriate for the board to maintain, change or withdraw its recommendation. If the board takes these steps, then a Delaware court should defer to its decision to maintain or change its recommendation.