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October 24, 2008

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DELAWARE COURT APPLIES THE "ENTIRE FAIRNESS STANDARD" IN DETERMINING THAT 35% STOCKHOLDER'S PREFERRED STOCK INVESTMENT WAS UNFAIR

Invokes extraordinary remedy of reforming the investment to convert voting preferred stock into non-voting common stock, but defers decision on potential liability of individual directors

In an opinion that highlights the pitfalls of the exercise of control rights by stockholders owning large, but less than majority, blocks of stock, Vice Chancellor Strine of the Delaware Court of Chancery recently ruled in *In re Loral Space and Communications Inc.*[1] that the terms of MHR Fund Management LLC's investment in Loral did not satisfy either the fair dealing prong or the fair price prong of the entire fairness standard under Delaware law. Rather than awarding damages to the plaintiffs, however, the Court took the rather extraordinary step of reforming MHR's investment on terms more favorable to Loral, including by converting the security from voting preferred stock into non-voting common stock.

Vice Chancellor Strine has employed his typically compelling and entertaining prose to provide important guidance to corporate directors and their advisors in structuring interested party transactions.

Background

Loral, a publicly traded company specializing in commercial satellite manufacturing and satellite-based telecommunications services, emerged from bankruptcy in 2005 with MHR, a fund engaged in the business of taking control of and turning around distressed companies, owning 35.9% of the outstanding common stock.[2] An MHR "selected investment advisor" was installed as Loral's CEO and he, together with another MHR "selected investment advisor" and the three principals of MHR, constituted a majority of Loral's nine-member board of directors. Despite its emergence from bankruptcy, Loral soon found itself in need of capital to address liquidity shortfalls and to fund future growth and expansion.

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[1] *In re Loral Space and Communications Inc.,* C.A. Nos. 2808-VCS, 3022-VCS (Del. Ch. Sep. 19, 2008).
[2] MHR, which converted some of its large holdings of Loral debt into equity in the bankruptcy, continued to hold large positions in several debt instruments issued by Loral and its subsidiaries post-bankruptcy.

MHR, supported by Loral's CEO, responded to Loral's need for capital by offering a $300 million equity investment which would enable MHR to maintain, and in fact enhance, its control position. Without considering the availability of other types or sources of financing, the Loral board formed a two-member Special Committee with the fairly specific mandate of evaluating and negotiating MHR's investment proposal to the exclusion of other potential proposals. The Chairman of this Committee was one of MHR's "selected investment advisors". After a 45-day delay, the Committee retained a relatively unknown firm, North Point Advisors, as its financial advisor. Thereafter, the basic economic terms of MHR's investment were rapidly negotiated and approved by the Special Committee within a period of less than two weeks, culminating in the signing of a term sheet with MHR.

Despite the fact that the Special Committee was told that Loral was in immediate need of the financing from MHR, following the signing of the term sheet, the CEO engaged in protracted, months'-long negotiations with MHR over the definitive terms of the investment. The convertible preferred stock ultimately issued contained very favorable terms for MHR. In addition to granting the holder of the preferred stock extraordinary class voting rights over any amendment to Loral's Certificate of Incorporation, whether in connection with a merger or other M&A transaction or otherwise, that could "adversely effect" the holders of the preferred stock, the holders of the preferred stock were given the right to put their shares upon a change of control for either $450 million in cash or additional common stock that would result in MHR owning, in the aggregate, 63% of Loral's equity. Finally, the holders of the preferred stock were given the right to elect one additional director to the Loral board.

Because the newly issued preferred stock would have effectively vested MHR with control over more than 58% of Loral's total equity and would have given MHR negative control over various corporate actions, the Special Committee was concerned that the investment would trigger the board's obligation under *Revlon*[3] to market the company and seek the highest value for stockholders. To address the *Revlon* issue, instead of exploring other alternatives for raising the financing, the terms of the preferred stock were structured to cap MHR's voting power at 39.9% of the total voting power outstanding.[4]

Claims and Defenses

The plaintiffs, two institutional investors, commenced litigation against MHR and the Loral directors, alleging that the investment "was grossly unfair to Loral, and resulted from fiduciary misconduct by the Loral directors." Specifically, the plaintiffs claimed that "the Special Committee bent to the will of MHR, allowing it the chance to increase its ownership stake to 63% and to obtain an iron grip over the Company's future, on terms that were unfavorable to Loral." Moreover, because "MHR had effective control over the Loral board," the plaintiffs maintained that the defendants should bear the burden of proving that MHR's investment was fair.

The defendants countered that the MHR financing was "a fair method of providing Loral with sorely needed capital" and that no alternative source was available on better terms or within the time frame sought. Because MHR went into the transaction owning "only" 35.9% of the outstanding common stock, the defendants contended that MHR was not Loral's controlling stockholder and that, therefore, the entire fairness standard was not applicable. Rather, the argument went, the favorable presumption of the business judgment rule should apply to the board's actions.

The Court's Analysis

Entire Fairness. At the outset of his analysis, Vice Chancellor Strine determined that the entire fairness standard was applicable to the MHR financing. The Court noted that "regardless of whether MHR was a controlling stockholder of Loral, the MHR Financing was an interested transaction" because a majority of the Loral board was affiliated with MHR and able to exert influence in determining the terms of the MHR financing,[5] thereby requiring application of the entire fairness standard.

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[3] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,* 506 A 2d 173 (Del. 1986).
[4] Although not central to the Court's decision because the stricter entire fairness standard was applied, Vice Chancellor Strine was clearly displeased that the Special Committee and its advisors, instead of "exploiting" the opportunity to invoke its *Revlon* obligations and shop the company, "simply maneuvered to avoid a technical invocation of *Revlon* duties." Employing terminology reminiscent of *Revlon*, the Court recognized that the terms of the financing, in conjunction with the Special Committee's decision to eschew a market check for alternative financing, "effectively turned MHR from a stockholder with the practical ability to control Loral, into one with absolute negative voting control and a right to 63% of the company's equity," thereby requiring as a practical matter that "anyone who desires to take control of Loral will be obligated to hold a separate negotiation with MHR over whether to pay it a non-ratable share of the control transaction price."
[5] In contrast to the meaning of "control" for *Revlon* purposes, which examines whether the stockholder, after the transaction in question has completed, will maintain the right to a control premium in any future transaction.

Although not necessary to his decision to apply the entire fairness standard, the Vice Chancellor clearly had little patience for the defendants' contention that MHR was not Loral's controlling stockholder, writing that "MHR's belated protestations that it was not a controlling stockholder after all are not convincing. … [T]he question is whether the blockholder, 'as a practical matter, possesses a combination of stock voting power and managerial authority that enables him to control the corporation, if he so wishes.' " In response to this question, Vice Chancellor Strine found that "MHR possessed such practical power over Loral, and that power shaped the process for considering and approving the MHR Financing." Among the factors cited by the Court in making this determination were:

- Both Loral and MHR "consistently and publicly maintained that MHR controls Loral."
- A majority of the Loral directors were either MHR principals or "selected investment advisors" of MHR, and one of these advisors was designated by MHR to serve as Loral's CEO.
- "With 36% of the votes, MHR hardly feared a proxy fight, and although it did not have the power to unilaterally vote in charter changes or effect a merger, it had substantial blocking power", including the power to block alternative financings that might otherwise have been available to Loral.
- As demonstrated by the process followed by the board, it was "evident that MHR controlled Loral's decision to pursue the growth strategy that necessitated additional capital financing and the time table for obtaining that capital."
- The board's designation of the Special Committee, consisting of what it apparently considered to be independent directors, was itself a recognition that a transaction with MHR would be examined under the entire fairness standard, with the resulting need to establish an independent committee in an attempt to shift the burden of proving fairness to the plaintiffs.

Burden of Proof. Having determined the applicability of the entire fairness standard to the MHR financing, the Court next turned to the question whether the appointment of the Special Committee had shifted the burden of proof from the defendants to the plaintiffs to prove a lack of both fair dealing and fair price, the twin prongs of the entire fairness test. Vice Chancellor Strine clearly was not impressed with either the composition or the mandate of the Special Committee, and was particularly critical of its performance. Accordingly, the Vice Chancellor determined that the burden remained with the defendants to prove that MHR's investment was fair to Loral.

Fair Dealing and Fair Price. The Court found that the defendants did not satisfy their burden of proving the fairness of the transaction. According to Vice Chancellor Strine, "this case is a good illustration of the relationship between the process used to effect a transaction and the defendants' ability to meet their burden to demonstrate financial fairness. When the process used involves no market check and the resulting transaction is a highly unusual one impossible to compare with confidence to other arms-length transactions, the court is left with no reasoned basis to conclude that the outcome was fair."

With respect to ***fair dealing***, the Court noted that the "inquiry is fact intensive and '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 stockholders were obtained.' " Or in other words, "[t]he critical issue here is whether the Special Committee functioned as an effective proxy for arms-length bargaining, such that a fair outcome equivalent to a market-tested deal resulted. An effective special committee 'must function in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power at an arms-length.' " Among the factors cited by the Court in concluding that the Special Committee did not demonstrate such bargaining power were:

- The Special Committee was comprised of only two members and was otherwise "flawed"; not only did neither member have any expertise in the satellite industry, but:
  - The Chairman was a "selected investment advisor" to MHR and a close friend of MHR's controlling principal, he sought investments from MHR in unrelated businesses with which he was associated while the Special Committee was in place and he forwarded internal Special Committee communications to MHR which included the Committee's fallback positions on a key negotiating points.

  - The other Committee member had no experience in serving on special negotiating committees, went on vacation during the process and generally participated in meetings by conference hook-up, "brought the scientific concept of inertia to the Special Committee by generally remaining at rest until set in motion by the Committee's advisors," was "confused about the status of key issues at several points throughout the process" and "demonstrated neither the knowledge nor the inclination to prod … [the Chairman] and the Special Committee's advisors towards an effective and aggressive strategy to ensure Loral got a fair deal."

- The Special Committee's financial advisor had no particular expertise in the satellite industry or in structuring convertible preferred stock investments, "was outgunned and outwitted" and "not qualified to swim in the deep end," did not conduct a market check before advising the Special Committee to agree to the basic economic terms proposed by MHR, appeared to lean heavily on MHR's more high-powered advisor Deutsche Bank and apparently skewed its fairness analysis to promote the fairness of the MHR financing.

- Although the Special Committee did retain reputable and experienced legal counsel, that was not enough to overcome the other deficiencies in the process, particularly in light of the fact that counsel was excluded from key aspects of the negotiation of the open issues.

- The Special Committee's "cramped view of its mandate" led it to reach agreement on basic terms elatively quickly (despite the fact that there was no real emergency in terms of Loral's need for liquidity) with MHR, without conducting a market check, and it continued to avoid a market check even though the final negotiations for the terms of the financing dragged on over several months.

- The Special Committee largely deferred to Loral's conflicted CEO in the negotiation of the terms of the preferred stock investment with MHR, apparently, on several occasions, avoiding using leverage against MHR to attempt to negotiate better terms.

With respect to ***fair price***, the Court rejected the defendants' argument that MHR was the only source of capital available to Loral at the time and that MHR's compensation for its investment risk was justified. Among the factors cited by the Court in finding that the price was not fair were:

- The Special Committee failed to pursue proposals for alternative financing received from Goldman Sachs and a large institutional stockholder.[6]

- The basic financial terms of the financing, including the dividend and conversion rates, "were favorable to MHR in comparison to the comparables" provided by the Special Committee's financial advisor.

- MHR also was granted a $6.75 million placement fee, plus nearly $2 million in expense reimbursement, which in effect acted as a "price cut" for MHR, even though it placed the financing with itself rather than a third party.

- The voting rights, and particularly the class voting rights, associated with the preferred stock "gave MHR an iron grip on Loral and the ability to extract a control premium for itself in any future Change of Control."

- At trial, expert testimony pointed out flaws in the fairness analysis employed by the Special Committee's financial advisor.

- The then-current trading price of Loral stock, which was used to fix the conversion rate, "is not an entirely reliable estimate of value" in a case in which the interested stockholder possesses non-public projections and "conducts an analysis resulting in a valuation of the corporation that is well above its trading price."

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[6] In addition, Loral's traditional banker, Morgan Stanley, had recommended alternative financing consisting of a new revolving credit facility and a public offering of common stock, but neither MHR or the Special Committee apparently had any interest in exploring this approach.

While none of the factors listed above was individually dispositive, "the sheer accumulation of examples of timorousness and inactivity … contributes to my conclusion that this Special Committee did not fulfill its intended function" or act "as an effective guarantor of fairness."

Remedy. Rejecting the plaintiffs' demand for a "very large damages award" and recognizing that "the transaction was of the kind that implicates the core concerns animating the *Revlon* doctrine", the Court concluded that the best manner to equitably remedy MHR's unfair investment was to "take MHR and the Special Committee up on their desire to avoid a *Revlon* deal" by reforming MHR's voting preferred stock into non-voting common stock on terms fair to Loral. This dramatic remedy left MHR with 57% of Loral's total equity and its prior voting power of 35.9%, and removed MHR's ability unilaterally to veto Loral's strategic initiatives.

Having invoked this equitable remedy, the Court did not find it necessary to examine whether any of Loral's directors had breached their fiduciary duties. The Court viewed the entire fairness test as one "designed to address a transaction's sustainability," but inadequate to determine liability for breach of fiduciary duty. According to the Court, "being a non-independent director who approved a conflict transaction found unfair does not make one, without more, liable personally for harm caused. Rather, the court must examine that director's behavior in order to assess whether the director breached her fiduciary duties and, if a § 102(b)(7) clause is in effect, acted with the requisite state of mind to have committed a non-exculpated loyalty breach."[7]

Conclusion

The *Loral* decision highlights the risks of failing to properly structure interested party transactions. Because the Delaware Court of Chancery is a court of equity, the chancellors are not constrained to awarding monetary damages or enjoining transactions, but rather will fashion creative remedies to address circumstances that they determine to be unfair to corporations and their public stockholders. Vice Chancellor Strine's opinion is chock-full of important guidance for corporate dealmakers in structuring transactions between corporations and their controlling stockholders, including:

- A stockholder who exercises a high degree of control over a corporation and its board of directors might be viewed as a "controlling stockholder" – thereby triggering the applicability of the entire fairness standard to transactions between the stockholder and the corporation – even though its actual voting stock holdings represent less than a majority of the outstanding voting power. It is important to take into account all positive and negative control rights, both at the stockholder and the board level.

- A board of directors' *Revlon* obligations may arise even when an investor is acquiring a controlling position in, though less than 100% of, a corporation's equity.

- When the entire fairness standard is applicable, the courts will carefully examine the composition of a special committee, the enabling resolutions establishing the committee's mandate and authority and the process followed by the committee in carrying out its duties.

- Significant personal and business relationships between special committee members and the interested party to the transaction will cause a committee member not to be deemed independent from the interested party.

- As we have seen in recent years in the case of directors seeking to satisfy their duty of care in the context of a *Revlon* transaction, active involvement on the part of special committee members and the consideration of reasonable alternatives to the transaction in question will be required.

- When the interested party transaction involves a change in control of the corporation, the techniques used to satisfy *Revlon* obligations, including a market check for alternative transactions, may be required.

[7] For a recent discussion of the Court of Chancery's views with respect to personal director liability under Section 102(b)(7) of the Delaware General Corporation Law, see our recent Client Alert titled *"Recent Delaware Decisions Temper Concerns Arising From Ryan v. Lyondell Discussion of Director Liability Under DGCL Section 102(b)(7),"* September 11, 2008.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

Beijing
Units 05-06, 15th Floor, Tower 2
China Central Place, 79 Jianguo Road, Chaoyang District
Beijing 100025, China

Anthony Root	+86-10-5969-2777	aroot@milbank.com
Edward Sun	+86-10-5969-2772	esun@milbank.com

Frankfurt
Taunusanlage 15
60325 Frankfurt am Main, Germany

Norbert Rieger	+49-69-71914-3453	nrieger@milbank.com

Hong Kong
3007 Alexandra House, 18 Chater Road
Central, Hong Kong

Anthony Root	+852-2971-4842	aroot@milbank.com
Joshua Zimmerman	+852-2971-4811	jzimmerman@milbank.com

London
10 Gresham Street
London EC2V 7JD, England

Stuart Harray	+44-20-7615-3083	sharray@milbank.com
Thomas Siebens	+44-20-7615-3034	tsiebens@milbank.com

Los Angeles
601 South Figueroa Street
Los Angeles, CA 90017

Ken Baronsky	+1-213-892-4333	kbaronsky@milbank.com
Neil Wertlieb	+1-213-892-4410	nwertlieb@milbank.com

Munich
Maximilianstrasse 15 (Maximilianhoefe)
80539 Munich, Germany

Peter Nussbaum	+49-89-25559-3636	pnussbaum@milbank.com

New York
One Chase Manhattan Plaza
New York, NY 10005

Scott Edelman	+1-212-530-5149	sedelman@milbank.com
Roland Hlawaty	+1-212-530-5735	rhlawaty@milbank.com
Thomas Janson	+1-212-530-5921	tjanson@milbank.com
Robert Reder	+1-212-530-5680	rreder@milbank.com
Alan Stone	+1-212-530-5285	astone@milbank.com
Douglas Tanner	+1-212-530-5505	dtanner@milbank.com

Singapore
30 Raffles Place, #14-00 Chevron House
Singapore 048622

David Zemans	+65-6428-2555	dzemans@milbank.com
Naomi Ishikawa	+65-6428-2525	nishikawa@milbank.com

Tokyo
21F Midtown Tower, 9-7-1 Akasaka, Minato-ku
Tokyo 107-6221 Japan

Darrel Holstein	+813-5410-2841	dholstein@milbank.com
Bradley Edmister	+813-5410-2843	edmister@milbank.com

Washington, DC
International Square Building, 1850 K Street
Washington, DC 20006

Glenn Gerstell	+202-835-7585	gerstell@milbank.com