FEATURE ARTICLE 1

ANNUAL SURVEY OF JUDICIAL DEVELOPMENTS PERTAINING TO VENTURE CAPITAL[1]

The primary purpose of the Annual Survey Working Group is to monitor and summarize judicial decisions related to venture capital that we believe are of the greatest interest to practitioners. [2]

CASES COVERED

The following decisions are summarized in this year's Annual Survey:

1, *Andrew Shiftan et al. v. Morgan Joseph Holdings, Inc.* -- Redemption Rights as a Factor in Appraisal Proceedings.

2. *Alta Berkeley v. Omneon* -- Conversion Prior to Liquidation Event Eliminates Liquidation Preference Rights.

3. *Zimmerman v. Crothall* -- Standard of Review and Rights Offerings in Context of Inside Down Round.

4. *Fletcher v. Ion* -- Blocking Rights over Note Issuance and Definition of "Security".

5. *In Re: Appraisal of the Orchard Enterprises, Inc.* -- Liquidation Preference Disregarded in Context of Appraisal Action.

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[1] By the Annual Survey Working Group of the Venture Capital Transactional Issues and Documents Subcommittee, Private Equity and Venture Capital Committee, ABA Section of Business Law. The Working Group is chaired by Jon Gworek of Morse, Barnes-Brown & Pendleton in Waltham, Massachusetts. Contributors in addition to Jon Gworek include Sayre Stevick and Andrew Albertson of Fenwick & West; Joshua Geffon of Stradling Yocca Carlson & Rauth; Lisa Stark of Berger Harris; Robert Friedel of Pepper Hamilton; and Daniel Sieck of McLane.

[2] To be included in this annual survey, cases must meet the following criteria: (a) the decision must address either a preferred stock financing or a change in control of a company that had previously issued preferred stock; or (b) the court must (i) interpret preferred stock terms; (ii) interpret a statute pertaining to a preferred stock financing; or (iii) address a breach of fiduciary duty claim brought in the context of a transaction described in (a) above.

6. *Greenmont Capital Partners I, LP v. Mary's Gone Crackers, Inc.* -- Class Voting Rights and Conversion Provisions.

CASE SUMMARIES

1. ANDREW SHIFTAN ET AL. V. MORGAN JOSEPH HOLDINGS, INC. (REDEMPTION RIGHTS AS A FACTOR IN APPRAISAL RIGHT PROCEEDINGS)

I. Summary.

In *Andrew Shiftan et al. v. Morgan Joseph Holdings, Inc.*, 57 A.3d 928 (Del. Ch. 2012), the Delaware Court of Chancery (the "Court") expanded the existing Delaware jurisprudence concerning the relevance of future events in appraisal proceeding valuations. Secondarily, the Court addressed rules of construction and the impact of parol evidence in the context of preferred stock provisions in a certificate of incorporation. The Court granted the motion for partial summary judgment filed by the petitioners, who were holders of preferred stock in Morgan Joseph Holdings, Inc. ("MJH"), an investment bank that had engaged in a merger transaction. The case arose in the context of the petitioners' exercise of appraisal rights following the merger.

II. Background.

The petitioners bought their preferred stock in MJH in 2001, when MJH was founded. The certificate of incorporation of MJH (the "Certificate") set forth the rights and designations of the preferred stock. In December 2010, MJH merged with another investment bank, as a result of which both MJH and the other investment bank became wholly-owned subsidiaries of a newly formed holding company ("Newco"). Pursuant to the merger, the preferred stock in MJH held by the petitioners was converted into new shares of preferred stock in Newco. Rather than accept the conversion in the merger, the petitioners exercised their appraisal rights under Section 262 of the Delaware General Corporation Law ("DGCL"). At issue in the instant action was a provision of the Certificate which provided for mandatory redemption of the preferred stock for $100 per share on July 1, 2011, six months after the merger took place. The petitioners argued that the $100 per share redemption price should be taken into account by the Court in its appraisal valuation. MJH, on the other hand, made two independent arguments. The first was that the mandatory redemption of the preferred stock was not in fact mandatory as it was subject to a condition that MJH have "excess cash" on the redemption date, and that as a result, there was no certainty that MJH would ever have been required to redeem the preferred stock. MJH's second argument was that because the automatic redemption was to occur six months after the merger and was therefore never triggered, the redemption price should not be taken into account in the Court's appraisal valuation exercise.

The Certificate provided for two alternative types of redemption of the preferred stock – automatic (i.e. mandatory) and optional. Under the optional redemption provision, the preferred stockholders would be entitled to elect to have their shares redeemed at a specified per share price in the event a specified financial covenant relating to "excess cash" were satisfied. Under the automatic redemption provision, all outstanding shares of preferred stock were to be mandatorily redeemed at the earliest to occur of July 1, 2011 or any one of several enumerated sale and change of control events, without any reference to "excess cash." A subsequent provision of the Certificate, dealing with the mechanics of automatic and optional redemption in a single section, introduced a possible ambiguity as to whether mandatory redemption was subject to the availability of "excess cash."

III. Analysis.

Although the Court spent only one-tenth of its opinion dealing with the appraisal valuation issue, this would seem to be the aspect of the case that will have the most relevance for future appraisal action disputes. In this regard, the Court reviewed that its charge in an appraisal proceeding "is to 'determine the fair value *of the shares* exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation,' taking into account 'all relevant factors.'" This includes "all non-speculative information bearing on the value of the shares at issue in an appraisal." Accordingly, the Court determined that when valuing the preferred stock in the appraisal action, the Court "must take into account the economic reality that the Series A would have been entitled to a mandatory redemption on July 1, 2011, just six months after the Merger."

The Court distinguished the instant case from *In re Appraisal of Metromedia International Group, Inc.*, 971 A.2d 893 (Del. Ch. 2009), a Delaware appraisal case in which the preferred stock designations provided for a liquidation preference of $50 per share as well as the right of the issuer, at its option, to redeem the preferred stock for $50 per share. In *Metromedia*, the preferred stockholders argued that the stated liquidation preference / redemption price should be taken into account in valuing the preferred stock in the appraisal proceeding, on the basis that there would probably have been a liquidation event within the next three to five years, resulting in the payment of the $50 per share liquidation preference plus accrued and unpaid dividends to the preferred shareholders. The court in *Metromedia* rejected this argument as "'speculative in that it assumes the probability of a future event, that is not certain to occur, and that has not occurred as of the appraisal date.'"

In contrast, the Court in the instant case pointed out that the mandatory redemption provision in the Certificate provided the preferred shareholders with the "specific, non-speculative contractual right" to have their shares redeemed for $100 on a date certain, only six months after the merger. The Court explained that "[a]s a general rule, preferred stock has the same appraisal rights as common stock, but '[u]nlike common stock, the value of preferred stock is determined solely from the contract rights conferred upon it in the certificate of designation.' Therefore, when determining the fair value of preferred stock, the court must consider the contract upon which the preferred stock's value was based." As a result, the Court concluded that at the trial stage, the Court will first have to determine the fair value of MJH as a going concern as of the merger date, and then determine the percentage of that fair value that is allocable to the holders of the preferred stock versus the common stock, taking into account, among other factors, the contractual right of the preferred stockholders to be redeemed six months hence for $100 per share, subject only to the availability of legally available funds for distribution.

After determining that the reading of the Certificate proffered by MJH was strained, the Court held that mandatory redemption was not subject to an "excess cash" condition. In its analysis, the Court discussed a number of legal principles applicable to the interpretation of preferred stock designations. One such principle is the doctrine of *contra preferentum* – the proposition that ambiguities are to be resolved against the drafter of a document. In the context of preferred stock designations, the Court explained that this principle means that "if a certificate of designation can be reasonably read in the manner the investor in preferred stock advances, the ambiguity should be resolved in her favor." Another principle is that where an ambiguity is found in a certificate of incorporation, available parol evidence may be consulted. In the instant case, the petitioners presented offering materials used by MJH in connection with the original sale of the preferred stock. According to the Court, these offering materials make clear that mandatory redemptions would not be subject to an "excess cash" condition.

In dicta, the Court posited a hypothetical case wherein preferred stockholders argue that a certificate of designation for preferred stock grants the stockholders a particular preference, but the court determines that the provision is ambiguous. There is no parol evidence on the subject. The Court pondered, but did not resolve, whether the principle of *contra preferentum* should apply, granting victory to the preferred stockholders, or whether the corporation should win based on the line of Delaware precedent that provides that preferences claimed by preferred stockholders must be clearly set forth in the governing document and will not be presumed or implied by the court. This potential conflict was determined not to be implicated in the instant case because the Court not only determined that the Certificate was unambiguous, but also that parol evidence was available that eliminated any arguable ambiguity in the relevant provisions of the Certificate.

IV. Conclusion.

Shiftan expands the Delaware jurisprudence of appraisal valuation by holding that a fixed, mandatory redemption right, that would have unquestionably taken place with the passage of time had the event giving rise to the appraisal action not taken place, will be taken into account in a court's valuation of a corporation in an appraisal. It is "a non-speculative contractual feature that must be taken into account in the court's determination of fair value." Additionally, the case holds that where a preferred stock certificate of designation is ambiguous, a court will take into account relevant parol evidence to clarify the ambiguity.

2. ALTA BERKELEY VI C.V., ALTA BERKELEY VI S BY S C.V., AND KIWI II VENTURA SERVICOS DE CONSULTORIA, S.A. VS. OMNEON INC. (CONVERSION PRIOR TO LIQUIDATION EVENT ELIMINATES LIQUIDATION PREFEERENCE RIGHTS)

I. Summary.

In *Alta Berkeley VI C.V., Alta Berkeley VI S By S C.V., and Kiwi II Ventura Servicos DE Consultoria, S.A. vs. Omneon Inc*. ("Omneon"), the Supreme Court of the State of Delaware interpreted the definition of a "Liquidation Event" in Omneon's certificate of incorporation (the "Certificate") in connection with the implementation of the automatic conversion provisions of the Certificate. In connection with its acquisition by Harmonic, Inc. ("Harmonic"), all (except for one series) of Omneon's preferred stock was automatically converted (the "Conversion") into shares of its common stock pursuant to the automatic conversion provisions of the Certificate immediately prior to the consummation of the acquisition. The liquidation preference that the holders of the Series C-1 Preferred Stock (the "Series C") would have obtained without giving effect to the Conversion was greater than the value of the merger consideration that such shareholders received as a result of the Conversion. The holders of the Series C argued that the Conversion was part of a Liquidation Event as defined in the Certificate because the Conversion was part of a "series of related transactions" that constituted a part of a Liquidation Event. The court concluded that the Conversion was not part of a Liquidation Event because (i) the Conversion was not a transaction in which Harmonic acquired Omneon, and (ii) the Conversion preceded the merger which, the court found, was the only transaction constituting a Liquidation Event.

II. Background.

Omneon is a privately-held technology company and Harmonic, Inc. is a publicly-held technology company. Omneon and Harmonic entered into a merger agreement (the "Merger Agreement") whereby Harmonic would acquire Omneon in a merger. The Merger Agreement provided that the Series A-2.2 Preferred Stock (the "Series A") would receive its liquidation preference, as required by the Certificate, and the merger would not be consummated until the remaining preferred shareholders approved the Conversion. For every series of Omneon's preferred stock except for the Series A and the Series C, the liquidation preference amount was less than the value of the merger consideration that such shareholder would receive as a result of the Conversion. The Series C shareholders filed a complaint, seeking damages equal to the difference between their liquidation preference and the merger consideration they received as a result of the Conversion. The Series C shareholders claimed that they were entitled to their liquidation preference payout, because the Conversion was a part of a "Liquidation Event" as defined the Certificate.

III. Analysis.

The Certificate defines a Liquidation Event (a "Liquidation Event") as follows:

> . . . a liquidation shall be deemed to be occasioned by, or to include, (i) the acquisition of the Company by any person or entity by means of any transaction *or series of related transactions* by the Company or its stockholders in which the stockholders of the Company immediately prior to such transaction *or series of related transactions* own less than 50% of the Company's voting power immediately after such transaction *or series of related transactions* (including, without limitation, any reorganization, merger or consolidation)…

The Series C shareholders argued that the Conversion was part of a Liquidation Event because the Conversion was part of a "series of related transactions" that constituted a part of a Liquidation Event. The court concluded that the Conversion was not part of a Liquidation Event because (i) the Conversion was not a transaction in which Harmonic acquired Omneon and (ii) the Conversion preceded the merger which, the court found, was the only transaction constituting a Liquidation Event. The court reasoned that the definition of Liquidation Event only refers to transactions that involve an acquirer that gains some incremental voting power or stock in each component transaction, and that eventually obtains majority voting power at the completion of the series of related transactions and, with respect to the Conversion, Harmonic did not acquire Omneon or any part of its stock.

IV. Conclusion.

Implementing the automatic conversion provisions of a Delaware corporation's certificate of incorporation immediately prior to a specified transaction (e.g. initial public offering, change of control and recapitalization) is a common technique utilized by practitioners. The Omneon case supports the view that the automatic conversion will be treated as a distinct transaction that is consummated prior to the specified transaction. That said, the vigilant practitioner must be careful to draft the certificate of incorporation such that the automatic conversion provision, the definition of a Liquidation Event and the related and similar provisions operate as intended.

3. ZIMMERMAN V. CROTHALL (STANDARD OF REVIEW AND RIGHTS OFFERINGS IN CONTEXT OF INSIDE DOWN ROUND)

I. Summary.

In *Zimmerman v. Crothall*, C.A. No. 6001-VCP, 2012 WL 707238, at *1 (Del. Ch. Mar. 27, 2012), the plaintiff Robert Zimmerman ("Zimmerman") claimed in part that certain directors breached their fiduciary duties in connection with a down round financing because the existing investors sat on the board of directors of the issuer, and the directors and/or their affiliates structured and led a down round financing on terms that were alleged to be unfair. The Delaware Court of Chancery (the "Court") first addressed the standard of review and determined that the entire fairness standard, not the business judgment rule, would apply in reviewing the transaction because of Zimmerman's allegation that the members of the board of directors of the issuer engaged in self-dealing. The defendant directors and controlling stockholders argued that a rights offering had been conducted as a result of which there was no self-dealing, and further that in the absence of self-dealing the transaction should be subject to review under the more deferential business judgment rule. The Court disagreed that a fair rights offering had been conducted because the rights offering had not been extended on equal terms to all owners.

II. Background.

Adhezion Biomedical, LLC ("Adhezion") was a Delaware limited liability company developing products in the medical products industry. Robert Zimmerman was the founder and a holder of Class A Common Units and Class B Common Units. Adhezion raised $3M in 2008 in exchange for Series A Preferred Units at $8 per unit establishing an $8M enterprise value for the company. Adhezion raised close to $2M in October of 2008 in exchange for the sale of additional Series A Preferred Units at $7.05 per unit establishing a $10.5M enterprise value. The financings that gave rise to the lawsuit followed, occurring between 2009 and 2011. In early 2009 Adhezion was negotiating a potential significant commercial license for its products with a large commercial partner. While this negotiation ensued, Adhezion needed additional capital and raised $525K through a bridge note financing. The bridge note investors included two of the Series A Investors (the "Lead Investors"), as well as two individual board members who were affiliated with one of the Lead Investors. Talks with the prospective licensor eventually broke down and Adhezion then entered into preliminary negotiations to sell the company. However, these discussions also broke off. Following these failed efforts and in urgent need of capital, in December of 2009 the company raised another $315K on the same terms as the prior bridge notes. Then in February of 2010 the company authorized the sale of approximately $3.25M of Series B Preferred Units at $4 per unit establishing an enterprise value of $13M, of which $2.5M was sold to the Lead Investors and their board representatives. The holders of Class A Common Units, including Zimmerman, were given the opportunity to participate in the Series B financing in the remaining $750K that was not purchased by the inside investors. Mr. Zimmerman did not participate. Following losses of more than $2M in 2010, in January of 2011 the company issued an additional $1,285,000 in bridge notes to the existing investors. These notes were convertible into Series B Preferred Units at $4 per unit. The holders of Class A Common Units were again offered the opportunity to participate in whatever was not purchased by the inside investors, and Mr. Zimmerman again declined.

Mr. Zimmerman filed suit against the company, certain of its investors including the Lead Investors, and members of the board of directors alleging breach of fiduciary duty, as well as related claims not discussed here, as a result of both the note offerings and the Series B financing that occurred between 2009 and 2011.

III. Analysis.

In evaluating the plaintiff's claims, the Court began the analysis by establishing the applicable standard of review. The Court stated that in reviewing claims against directors for breach of fiduciary duty, the burden lies on the plaintiff to "establish a general issue of material fact as to whether the directors were independent, disinterested, informed, or acting in good faith." If this burden is met, the transaction must be reviewed under the entire fairness standard. This standard is very onerous to meet, and may make it difficult for the defendants to prevail. If, however, this burden is not met the transaction is subject to the business judgment rule standard of review and the directors are afforded a great deal of deference in their decision making. As a result, the merits of a claim for breach of fiduciary duty can hinge significantly on this determination.

The main fiduciary duty question at issue in the *Zimmerman* case was whether the defendants were interested parties in the transaction engaged in self-dealing. The Court went on to specifically articulate the burden that the plaintiff must meet to bring an allegation of self-dealing within the entire fairness standard of review stating that the entire fairness standard of review will apply where a transaction is approved by a "majority of the directors or a controlling stockholder 'stand[ing] on both sides of the transaction, dictat[ing] its terms, and obtain[ing] a benefit not received by all stockholders generally.'" Therefore, if the benefit alleged was not "exclusive" to the defendants the transaction was not characterized by self-dealing and would be subject to the business judgment standard of review.

The Court then turned to the question of whether the investors and their designees received a benefit not received by all equity owners generally, and more specifically on the question of whether they had an opportunity not extended to all owners to buy equity in the company at a price that was allegedly unfair. The defendants argued in part that the opportunity to invest was not "exclusive" because a rights offering had been extended to other equity owners. The Court examined the facts related to the rights offering and found that the transactions did not "offer equal terms for all shareholders and, therefore, conferred an exclusive benefit." Of particular note, the Court pointed out that as a first step in the challenged financing transactions the preferred unit holders, including the defendants, were given the opportunity to purchase all of the offered securities. It was only after the preferred members had invested that certain common members were offered the opportunity to purchase their pro rata share of what remained available. In addition, the right to participate was not extended to all common members, just Class A Members, and the Class A Members participation level did not factor in their Class B ownership. The Court reasoned that if the preferred members purchased more than their collective pro rata share of the offerings, the financings would by definition be dilutive to the common members even if they participated to the fullest extent possible in what remained. Therefore the preferred members enjoyed an exclusive benefit not available to all members. From this conclusion, the Court determined that the transactions were self-dealing in nature and therefore subject to the entire fairness standard of review.

IV. Conclusion.

Zimmerman illustrates the likelihood that inside led down round financings may be subject to the more exacting entire fairness standard of review rather than the business judgment standard. *Zimmerman* also suggests that the element of self-dealing inherent in a down round financing, and which gives rise to this higher standard of review, may be eliminated if a rights offering is extended to all stockholders such that the members of the board of directors of the issuing company are not enjoying an exclusive benefit. At a minimum the *Zimmerman* case reinforces the prevailing view that a rights offering is a factor that helps to insulate the board of directors, and the transaction itself, from challenge based on an alleged breach of fiduciary duty resulting from the participation of insiders in a down round financing. From the issuer's perspective, the most favorable reading of the case would suggest that a fair and properly run rights offering will result in a review of the transaction under the business judgment rule, a standard that is highly deferential to the board of directors and would make a breach of fiduciary duty claim more difficult to establish. Regardless, *Zimmerman* provides very practical guidance on how an issuing company should conduct a rights offering in order to avail itself of the protections a rights offering provides.

V. Other.

While *Zimmerman* suggests a possible roadmap that could allow the board of directors of an issuing company in an inside led down round to avail itself of the benefits of the business judgment rule, issuers and their counsel trying to take advantage of the guidance offered in *Zimmerman* will nonetheless need to confront the issue of extending a rights offering to non-accredited investors in compliance with applicable securities laws.

4. FLETCHER V. ION (BLOCKING RIGHTS OVER NOTE ISSUANCE; DEFINITION OF A SECURITY)

I. Summary.

In *Fletcher International, Ltd. vs. ION Geophysical Corporation* (May 23, 2012), the Delaware Court of Chancery (the "Court") analyzed whether three promissory notes ("Notes") issued as part of the purchase of a business should be considered securities under federal and state securities law.

The Court sought to determine whether ION Geophysical Corporation ("ION") violated the rights of its preferred stockholder Fletcher International Ltd. ("Fletcher") by causing a subsidiary of ION ("Buyer") to issue the Notes to the seller of a business without Fletcher's approval. If any Note constituted a security, then Fletcher's consent rights over such issuance, as described in ION's Certificates of Rights and Preferences ("Certificates"), was violated.

II. Background.

The Buyer issued the Notes in connection with the consummation of an acquisition. One unsecured promissory note ("Escrow Note") included a purchase price adjustment tied to an escrow provision of the acquisition agreement. It was not convertible into equity, and included a maturity date of up to one year with escalating rates of interest to coincide with the repayment time frames. Buyer also issued a "Tax Receivable Note". Like the Escrow Note, this Note was unsecured and not convertible into equity. Interest was due one day after the Escrow Note's maturity date, and the interest rate was set at one percent above the interest rate on the Escrow Note. Simultaneously with this issuance, the terms of a senior credit facility were amended to require that both the Escrow Note and the Tax Receivable Note be repaid within three months.

Following the collapse of the credit markets, as part of a broader effort to refinance the acquisition, a new promissory note (the "Final Note") was issued that had a term of nearly five years and included a 15% interest rate payable quarterly. The principal of the Final Note was fixed nine months into its term.

All three Notes were guaranteed by ION, bore a legend disclaiming registration under securities laws, and were only transferable with ION's written consent (which could not be unreasonably withheld), unless an event of default existed and remained uncured, in which case the Notes were freely assignable.

III. Legal Analysis.

The Court began by noting that the term "any security" in the Certificates referred to "instruments generally recognized to be securities under federal and state securities statutes and regulations." The Court then provided that a determination as to whether a promissory note was a "security" required applying the test set forth by the U.S. Supreme Court in *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

Reves held that every promissory note is presumed to be a security under securities laws. This presumption may only be rebutted if the note fits within one of the specific categories explicitly excluded from the definition of a security, or bears a strong "family resemblance" to one of the excluded categories.

The categories of promissory notes that are explicitly excluded from the definition of a security include, among others, (1) short-term notes secured by a lien on a small business or some of its assets; (2) short-term notes secured by assignment of accounts receivable; (3) notes evidencing loans by commercial banks for operations; (4) notes evidencing a "character" loan to bank customers; and (5) notes that formalize open-account debt incurred in ordinary course of business.

Because the Notes did not fit within the excluded categories, the Court utilized the Reves' "family resemblance" test. That test required the Court to consider four relevant factors: (1) motivations that would prompt a reasonable buyer and seller to enter into the transaction; (2) plan of distribution of the note; (3) reasonable expectations of the investing public; and (4) whether some factor significantly reduces the risk of the instrument, rendering the application of securities laws unnecessary.

The Court found that the Escrow Note and the Tax Receivable Note were not "securities", but were rather short-term lending transactions among sophisticated parties. These Notes "were enmeshed in an intricate, short-term relationship with ION" since they related to the terms of the escrow in the acquisition and the receipt of a tax receivable and had to be repaid within three months. While they contained securities law legends and references and lacked risk-reducing factors (such as collateral), since these Notes were difficult to price or sell, no additional protection from securities law was required.

By contrast, the Final Note was deemed to be a "security". This Note was a long-term investment in ION that was transferable and offered a high rate of interest. This Note was issued only because ION could not obtain the funding that it had hoped to use to pay the seller. These factors were characterized as investment motives. Also, the recipients of this Note – the sellers in the acquisition transaction - appeared to have agreed to the Final Note in part to protect their equity investment - an investment decision. The Final Note was also the sort of instrument - like a high yield corporate bond - that investors regularly trade in secondary markets. For the Final Note, the securities legend and securities law references lent additional support to the finding that it was a security.

Because the Final Note was a security, its issuance without Fletcher's consent violated Fletcher's consent rights.

IV. Conclusion and Suggestion.

Practitioners should remember that promissory notes issued in an acquisition are presumptively securities. To overcome this presumption, counsel must be prepared to show that they fall within the specific categories explicitly excluded from the definition of a "security", or establish their strong "family resemblance" to one of those specific categories.

The case serves as a warning that promissory notes issued in acquisitions intended to be other than securities should be closely tied to the terms of the acquisition, short-term lending arrangements, not transferable, and not dependent upon the strength of the issuer's business. Otherwise, the notes may be deemed to be issued for investment motives, and viewed as securities.

5. IN RE: APPRAISAL OF THE ORCHARD ENTERPRISES, INC. (LIQUIDATION PREFERENCE DISREGARDED IN CONTEXT OF APPRAISAL ACTION)

I. Summary.

In *In Re: Appraisal of the Orchard Enterprises, Inc.*, C.A. No. 5713-CS (Del. Ch. July 18, 2012), the Delaware Court of Chancery (the "Court") rejected the argument that the preferred stock liquidation preference must be deducted from the enterprise value of The Orchard Enterprises, Inc. ("Orchard") when calculating the value of Orchard's common stock in an appraisal proceeding. Orchard's controlling stockholder, which owned common stock and a controlling preferred stock position, initiated a going private merger (the "Merger"). As a result of the Merger, the common stockholders were cashed out at a price per share that was based on the assumption that Orchard's enterprise value should be reduced by the preferred stock liquidation preference of the outstanding preferred stock. Certain holders of common stock exercised their appraisal rights challenging the fairness of this approach, and in the appraisal proceeding the Court rejected the approach taken by Orchard determining that it was improper to reduce the enterprise value by the preferred stock liquidation preference. The Court concluded instead that the common stock should be valued as though the preferred stock were converted to common stock thereby eliminating any impact of the liquidation preference. The Court determined that an as-converted basis for calculating the value of the common stock was proper because of the settled principal that Delaware appraisal actions are determined based on the entity's going concern value without regard to future transactions. The Court explained that in valuing the entity as a going concern, the preferred stockholder's only right to cash flow distributions of the company as a going concern was to receive dividends alongside the common stock on an as-converted basis.

II. Background.

Orchard distributes digital music, video, and other digital content through a variety of online retailers. Prior to the Merger, Orchard traded publically and had a capital structure that consisted of common stock, 42.5% of which was owned by Dimensional Associates, LLC ("Dimensional"), and preferred stock, convertible at any time at the option of the holder into 3.33 shares of common stock, which was effectively wholly owned by Dimensional. The preferred stock was entitled to receive a liquidation preference under certain events, including a transaction that resulted in a change in control. Based on the number of shares of preferred stock, the total liquidation preference was $25 million at the time of the Merger.

In 2009, after seeking buyers for Orchard with no success, Dimensional decided to buy out the common stockholders and take Orchard private. Dimensional made an offer for the outstanding common shares, and Orchard's board of directors formed a special committee to evaluate the offer and hired a financial advisor. In March 2010, the financial advisor delivered a fairness opinion that the price of $2.05 per share was fair. The common stockholders simultaneously approved the Merger and an amendment to Orchard's Certificate of Designations which established the terms of the preferred stock, thereby allowing Orchard to enter into the Merger. Significantly, the preferred stock was left in place following the Merger, and the liquidation preference remained payable to Dimensional in the event that one of the triggering events described in the Certificate of Designations occurred in the future. Thereafter the petitioners initiated this action claiming that the value of each Orchard common share was $5.42 at the time of the Merger.

III. Analysis.

Orchard argued that the liquidation preference was implicitly a negotiated part of the Merger pursuant to the amended Certificate of Designations. The amendment provided that the Merger, which was an otherwise prohibited change of control event, could only occur if the majority of preferred stockholders approved; and Dimensional had approved it. The court was un-persuaded in light of the plain language of the Certificate of Designations, which set forth that the liquidation preference was only triggered upon the occurrence of a third-party merger, dissolution, or liquidation. Concluding that the Merger was not a triggering event under the plain terms of Certificate of Designations, the court further strengthened its reasoning with the fact that the preferred stock remained outstanding, and the liquidation preference remained in place, as of the date of the Merger.

The Court also ruled out Orchard's argument that its ownership of essentially all preferred stock and its voting control over all equity increased the probability of its receipt of the liquidation preference in the future to a near certainty. Under Delaware law, petitioners in an appraisal action are entitled to their pro rata share of the entity's going concern value as of the date of the merger without regard to post-merger events or other possible business combinations.

The Court focused its analysis on the rights of the preferred stockholders to the operating cash flow of Orchard while the company was a going concern. Because the preferred stockholders were entitled to be paid dividends alongside the holders of common stock on an as-converted basis, the Court concluded that the preferred stockholder's going concern rights were the same as the holders of the common stock. The Court therefore concluded that the appraised value should not be reduced by the liquidation preference because the preference only became payable under very specific circumstances which were not triggered by the Merger. In addition the Court noted that on the date of the Merger the likelihood of an event triggering the liquidation preference was speculative and until such event occurred, if ever, Dimensional's sole claim on the cash flows of the company would be to receive dividends on an as-converted basis. The court therefore held that Orchard's stock must be valued on an as-converted basis, without regard to the preferred stock liquidation preference, for a per share value of $4.67.

IV. Conclusion.

The *Orchard* case reaffirms established Delaware law that in an appraisal action the value of the capital stock will be determined on a going concern basis. When the only right the preferred stockholders have with respect to the operating cash flow of the company as a going concern is to participate in any dividends paid by the company equally alongside the holders of common stock on an as-converted to common stock basis, any liquidation preference of the preferred stockholders will be disregarded in the appraisal proceeding unless the transaction giving rise to the appraisal proceeding itself triggers the liquidation preference rights.

V. Other.

The court also addressed certain technical corporate finance valuation issues. The court explained that if there are no clear comparable companies or transactions upon which to base a comparable or market-based valuation, a discounted cash flow analysis is appropriate. As for the discount rate, the court chose the capital asset pricing model over various versions of the build-up model, which it described as not accepted by mainstream corporate finance scholars.

6. GREENMONT CAPITAL PARTNERS I, LP V. MARY'S GONE CRACKERS, INC. (CLASS VOTING RIGHTS AND CONVERSION PROVISIONS)

I. Summary.

In *Greenmont Capital Partners I, LP v. Mary's Gone Crackers, Inc.*, C.A. No. 7265-VCP (Del. Ch. Sept. 28, 2012), the Delaware Court of Chancery rejected plaintiff's claim that the exercise of an automatic conversion feature in a preferred stock designation by the holders of a majority of the outstanding preferred stock of defendant violated a series blocking right on actions which would "alter or change" the rights of such series. The exercise of the conversion right resulted in the conversion of two outstanding series of preferred stock into common stock. Immediately after the effectiveness of the conversion, the defendant amended its certificate of incorporation to eliminate all references to the rights of the two series of previously outstanding preferred stock. The plaintiff argued that the subsequent charter amendment also violated a series blocking right even though all shares of preferred stock ceased to be outstanding upon the effectiveness of the conversion. The Court disagreed with plaintiff on both claims based on the application of longstanding principles governing the interpretation of preferred stock terms.

II. Background.

In September 2007, plaintiff Greenmont Capital Partners I, LP ("Greenmont") purchased five million shares of Series B Preferred Stock (the "Series B") of Mary's Gone Crackers, Inc. ("MGC") for $1 million. At the time, MGC's certificate of incorporation (the "Certificate") also authorized Series A Preferred Stock (the "Series A") and Common Stock. Under the Certificate, the Series B holders enjoyed a number of special rights, including blocking rights on any amendments to the Certificate and on any other actions which would alter the special rights, powers or preferences of the Series B. Specifically, Article IV, Section D.2(b) of the Certificate (the "Series B Blocking Right") provided, in pertinent part:

> For so long as any shares of [sic] Series B Preferred remain outstanding, in addition to any other vote or consent required herein or by law, the vote or written consent of the holders of at least a majority of the outstanding shares of the Series B Preferred shall be necessary for effecting or validating the following actions….:
>
> (i) Any amendment, alteration, repeal or waiver of any provision of the Certificate of Incorporation….;
>
> (ii) Any agreement or action that alters or changes the voting or other powers, preferences, or other special rights, privileges or restrictions of the Series B Preferred….

2012 Del. Ch. LEXIS 236, at *5. In addition to the Series B Blocking Right, Section D.5(l)(ii) of the Certificate provided the holders of the Series A and Series B with the right to force a conversion of their preferred stock into common stock upon the affirmative vote of the holders of a majority of the outstanding preferred stock, voting together as a class. In February 2012, MGC asked certain holders of the preferred stock to elect an automatic conversion (the "Conversion").

After receiving the requisite vote for the Conversion, MGC amended the Certificate to eliminate the preferred stock terms.

III. Analysis.

In this action, plaintiff argued that MGC was required to obtain a separate series vote of the Series B to effect the Conversion and the Amendment pursuant to the Series B Blocking Right. In evaluating plaintiff's claim, the Court began by reviewing Delaware principles of preferred stock construction: (1) the court must construe provisions of a certificate of incorporation under principles of contract construction; (2) rights, preferences and limitations of preferred stock must be expressly stated; and (3) preferred stock terms may not be presumed. Applying these principles, the Court found that the Conversion did not alter or change a right of the Series B. Rather, the Conversion resulted from the exercise of a right that existed on equal footing with the Series B Blocking Right. In reaching this decision, the Court also considered that there were corporate actions identified in the Certificate that required for their consummation not only a class vote of the preferred, but also a series vote of the Series B. In the Court's view, these provisions suggested that the drafters of the Series B terms knew how, but chose not, to protect themselves from the challenged actions.

Turning to the Amendment, the Court held that the Series B Blocking Right did not limit MGC's authority to eliminate the preferred stock terms because the Series B preferred stock ceased to be outstanding at the time of the Conversion and prior to the vote on the Amendment. The Certificate provided that the Conversion would occur "automatically" upon receipt of the requisite vote of the holders of preferred stock. The Court also considered whether the holders of the Series B possessed a right to vote on the Amendment, under Section 242(b)(2) of the Delaware General Corporation Law ("Section 242(b)(2)"), which, *inter alia*, creates class voting rights in connection with charter amendments that increase or decrease the number of authorized shares of a class. Like the Series B Blocking Right, Section 242(b)(2) only creates voting rights for "holders of outstanding shares." Thus, the Court found that Section 242(b)(2) did not afford the holders of formerly outstanding shares of Series B a vote on the Amendment. For the foregoing reasons, the Court denied plaintiff's motion for judgment on the pleadings as to all of its claims.

IV. Conclusion.

Greenmont Capital Partners I, LP v. Mary's Gone Crackers, Inc. is consistent with a long line of Delaware authority declining to exalt substance over form in the construction of protective provisions in preferred stock terms. Although the *Greenmont* decision did not detail the reasons for MGC's decision to solicit votes to trigger the automatic conversion feature, such provisions may be used as a first step in forcing a pay-to-play type transaction or other types of dilutive financings on existing investors absent careful drafting.

V. Other.

The Court also rejected plaintiff's argument that the Conversion and the Amendment be interpreted together, such that they collectively would be subject to the Series B Blocking Right. Relying on the doctrine of independent legal significance, which generally requires that corporate acts be evaluated separately, the Court rejected plaintiff's argument.