

Berger v. Pubco Corp., 2008 WL 2224107 (Del.Ch. 2008)

Delaware's short-form merger statute does not impose onerous burdens on parent corporations seeking to make use of its expeditious process for merging with subsidiaries. In fact, it simply mandates that the minority shareholders of the subsidiary be notified of their statutory right to appraisal. Such notice must include a copy of the appraisal statute and, of course, implicates the parent's fiduciary duty to disclose all material information with respect to the shareholder's decision whether or not to seek appraisal. Because the parent in this case failed both to attach a correct copy of the appraisal statute and to include all material information, the fiduciary duty of disclosure was breached. Consequently, the minority shareholders must now be given an opportunity to seek a quasi-appraisal remedy.

I. BACKGROUND

Plaintiff Barbara Berger owned an unknown number of shares of common stock in defendant Pubco Corporation (“Pubco” or the “Company”), which is organized under the laws of Delaware but which is not and was not a publicly traded corporation. In November 2007, Berger received a written notice from Pubco (the “Notice”) stating that the Company's controlling shareholder had effected a short-form merger and that she and the other minority shareholders were being cashed out for \$20 per share. That controlling shareholder was, in effect, defendant Robert H. Kanner, who was (and is) Pubco's president and sole director and who owned more than 90% of Pubco. Specifically, Kanner formed Pubco Acquisition, Inc., and transferred to it his Pubco holdings in order to effect the merger.²

Pursuant to the short-form merger statute, the Notice explained that shareholder approval was not required and that the minority shareholders had a right to seek appraisal. The Notice also contained some information about the nature of Pubco's business, the names of its officers and directors, the number of shares and classes of stock, a description of related business transactions, and copies of Pubco's most recent interim and annual financial statements. The Company, although not publicly traded, was traded sporadically over the counter, and the thirty open-market trades that occurred in the twenty-two months leading up to the merger ranged in price from \$12.55 to \$16.00, with an average price of \$13.32. Finally, the Notice provided telephone, fax, and email contact information where shareholders could obtain additional information upon request.

With the possible exception of the financial statements, the Notice did not provide much detail. For example, the description of the Company was a scant five sentences, one of which vaguely stated only that “[t]he Company owns other income generating assets.” There was no disclosure relating to the Company's plans or prospects, and no meaningful discussion of the Company's actual operations. There was no disclosure of the Company's finances by division or line of

² This maneuvering was necessary because the short-form merger statute is available only to corporate controlling shareholders. *See* 8 Del. C. § 253 (“In any case in which at least 90% of the outstanding shares of each class of the stock of a corporation ... is owned by *another corporation*...”).

business; instead, the unaudited financial statements lumped all of the Company's operations together. Moreover, although the financial statements indicated that the Company held a sizeable amount of cash and securities, there was no discussion or explanation of how those assets were utilized or were going to be utilized by the Company. Finally, the Notice contained no disclosure whatsoever of how Kanner determined the price at which he set the merger consideration.

As required by statute, the Company attached to the Notice a copy of the appraisal statute, but the copy attached was outdated and, therefore, incorrect. Although 8 *Del. C.* § 262 was updated by the General Assembly with changes that took effect in August 2007, the version attached to the Notice did not reflect those changes. The Company never sent a correct copy of the current appraisal statute to its minority shareholders.

On December 14, 2007, Berger initiated this case, purportedly as a class action representing the interests of all minority shareholders of Pubco. Berger claims that the class is entitled to receive the difference between the \$20 per share each member received and the fair value of his or her shares, regardless of whether or not a class member demanded appraisal. [...]

III. DUTY OF DISCLOSURE IN SHORT-FORM MERGERS

The so-called “duty of disclosure” is not quite “a separate and distinct fiduciary duty;” indeed, “[i]t represents nothing more than the well-recognized proposition that directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action.” The standard for determining materiality is well settled:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.... It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be 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.

In the context of a short-form merger, shareholders do not need to cast an informed vote on whether or not to effect the merger itself.¹⁰ Instead, “[w]here the only choice for minority shareholders is whether to accept the merger consideration or seek appraisal, they must be given all of the factual information that is material to *that* decision.” Importantly, “[t]he parent need not provide *all* the information necessary for the stockholder to reach an independent determination of fair value; only that information material to the decision of whether or not to

¹⁰ *Glassman v. Unocal Exploration Corp* (“[I]n a § 253 merger, [t]he minority shareholders receive no advance notice of the merger; their directors do not consider or approve it; and there is no vote.”).

seek appraisal is required.” Clearly, some financial data about the company is materially relevant to the decision of whether or not to seek appraisal, but such disclosure is ultimately asymptotic; it eventually becomes an exercise in diminishing returns. Additional information may always be helpful, but “[o]mitted facts are not material simply because they might be helpful [; ...] there must be a substantial likelihood that the undisclosed information would *significantly alter the total mix of information already provided.*” Thus, “plaintiffs must explain why receiving information *in addition to* the basic financial data already disclosed will significantly alter the total mix of information available.”

Here, defendants concede there was at least one problem with the notice distributed to minority shareholders: the wrong version of the appraisal statute was attached. The Delaware appraisal statute explicitly requires its inclusion in any notice of a merger giving rise to appraisal rights.¹⁵ It is undisputed that the Notice attached a noncurrent version of § 262, and this represents a clear violation.¹⁶ The parties disagree on the scope of the proper remedy, and they also dispute the materiality of the plaintiff's other alleged disclosure violations.

Plaintiff alleges there was a material omission because the Notice did not disclose how Kanner set the \$20 per share price. Defendants argue that it cannot be material, because it could not matter in the context of a short-form merger. Specifically, defendants argue that in a short-form merger the parent has no obligation to set a fair price and, therefore, has no obligation to explain how or why the price set is fair. Moreover, the defendants contend, holding that the process by which Kanner set the merger price was material would lead to a foolish *per se* rule. Defendants then list a series of absurd, hypothetical “methods” Kanner could have used, which range from unreliable valuation software to rolling dice. Because Kanner utilized the short-form merger statute, he did not have to set a fair price and, therefore, could have used any method—no matter how absurd—to set the merger consideration. Defendants argue that disclosure of his methodology is unnecessary.

Defendants' argument entirely misses the mark, however, because the issue is not about necessity—it is about materiality. In the context of Pubco, an unregistered company that made no public filings and whose Notice was relatively terse and short on details, the method by which Kanner set the merger consideration is a fact that is substantially likely to alter the total mix of information available to the minority shareholders. Where, as here, a minority shareholder needs to decide only whether to accept the merger consideration or to seek appraisal, the question is partially one of trust: can the minority shareholder trust that the price offered is good enough, or does it likely undervalue the Company so significantly that appraisal is a worthwhile endeavor? When faced with such a question, it would be material to know that the price offered was set by arbitrarily rolling dice. In a situation like Pubco's, where so little information is available about

¹⁵ See 8 Del. C. § 262(d)(2) (“[the] corporation ... shall include in any such notice a copy of this section”).

¹⁶ [...] The defendants do argue that the “unintentional attachment of the previous version of the appraisal statute was immaterial”, but then Vice Chancellor Jacobs dismissed this same argument in *Nebel v. Sw. Bancorp, Inc.* There, he wrote, “[i]n my view, any argument that [a technical violation of the appraisal statute] is ‘immaterial’ is foreclosed by the mandatory nature of the statutory requirement.... Where the legislature so commands but the command is not observed, the corporation cannot be heard to argue that its violation of the statute is not material.”

the Company, such a disclosure would significantly change the landscape with respect to the decision of whether or not to trust the price offered by the parent. This does not mean that Kanner should have provided picayune details about the process he used to set the price; it simply means he should have disclosed in a broad sense what that process was, assuming he followed a process at all and did not simply choose a number randomly. In a section 253 merger, the parent need not “set[] up negotiating committees, hire[] independent financial and legal experts, etc.” because it need not “establish entire fairness.” Nevertheless, the minority shareholders of an unregistered, non-reporting company are entitled to know at least whether the parent did or did not use such methods when setting the merger consideration, because such a fact “would have assumed actual significance in the deliberations of the reasonable shareholder” faced with the decision of whether or not to trust and accept the price offered by the parent.

Plaintiff's other arguments about alleged disclosure violations are less persuasive. Although plaintiff correctly notes that the description of the Company left much to the imagination, plaintiff has not explained why additional details about the products and services Pubco offered would have been materially relevant to the decision of whether or not to seek appraisal. Finally, plaintiff also challenges the financial information disclosed in the Notice. Specifically, Berger argues that defendants committed a material omission by failing to explain why the Company was sitting on \$96 million in cash and securities or what the Company planned to do with this money. Plaintiff's argument on this point and plaintiff's other criticisms of the financial information are effectively self-defeating. Plaintiff very rightly notes that the financial disclosures reveal that the Company held cash and securities that amounted to approximately \$36 per share-\$16 per share *more* than the merger consideration. This information does not indicate a material omission; it indicates that the minority shareholders should give serious thought to pursuing appraisal rights. In effect, plaintiff demonstrates that the financial information disclosed *has* allowed her to determine that she did not trust the parent's valuation of the Company. Because plaintiff has not explained why *additional* disclosures would significantly alter the total mix of information available in the Notice, she has not demonstrated the materiality of her alleged omissions.

IV. REMEDY

[This part of the decision was reversed on appeal (*Berger v. Pubco Corp.*, 2009 WL 1976529 (Del. 2009)). Below are portions of the Delaware Supreme Court's decision on the remedy.]

Because the plaintiff challenges a short form cash-out merger under Section 253, the starting point for analysis is *Glassman*, which holds that in a short-form merger there is no “entire fairness” review and that the exclusive remedy is a statutory appraisal. *Glassman* cautions, however, that those limited review and exclusive remedy protections are not absolute or unqualified. They are available only “absent fraud or illegality.” Moreover, “[a]lthough fiduciaries are not required to establish entire fairness in a short-form merger, the duty of full disclosure remains.... Where the only choice for the minority stockholders is whether to accept the merger consideration or seek appraisal, they must be given all the factual information that is material to that decision.”

The question not reached, and therefore not addressed, by *Glassman* is: what consequence should flow where the fiduciary fails to observe its “duty of full disclosure”? That is the only issue before us and it is one of first impression.

[...]

1) *The Remedial Alternatives*

[...] In the abstract, four possible alternatives present themselves, of which only two are advocated by either side. The remaining two alternatives are advocated by no party. We nonetheless identify and consider them, because to do otherwise would render our analysis truncated and incomplete.

The alternatives advocated by each side, respectively, are the two forms of “quasi-appraisal” remedy earlier described. The defendants argued, and the Court of Chancery agreed, that the appropriate remedy is the quasi-appraisal ordered in *Gilliland*. Under that remedial structure, fully informed minority shareholders who “opt in” and place into escrow a portion of the consideration they received may prosecute an action to recover the difference between adjudicated “fair value” and the merger consideration. The plaintiff advocated the second alternative form of “quasi-appraisal” remedy – a class action to recover the difference between “fair value” and the merger consideration, wherein the minority shareholders are automatically treated as members of the class with no obligation to opt in or to escrow any portion of the merger consideration. Under either structure, the only issue being litigated would be the appraised “fair value” of the corporation on the date of the merger, applying established corporate valuation principles.

Of the remaining two remedial alternatives (those advocated by neither side), the first would be a “replicated appraisal” proceeding that would duplicate the precise sequence of events and requirements of the appraisal statute. Under the “replicated appraisal” approach, the minority shareholders would receive (in a supplemental disclosure) all information material to making an informed decision whether to elect appraisal. Shareholders who elect appraisal would then make a formal demand for appraisal and remit to the corporation their stock certificates and the entire merger consideration that they received. Thereafter, the corporation would have the opportunity, as contemplated by the appraisal statute, to attempt to reach a settlement with the appraisal claimants. Where no settlement is reached, a formal appraisal action could then be commenced by the dissenting shareholders or by the corporation.

Under the fourth alternative (also not advocated by either side), there would be no remedial appraisal proceeding at all. Rather, the consequence of the fiduciary's adjudicated failure to disclose material facts would be to render *Glassman* inapplicable. As a result, the remedy would be the same as in a “long form” cash out merger under 8 *Del. C.* § 251 – a shareholder class action for breach of fiduciary duty, where the legality of the merger (and the liability of the controlling stockholder fiduciaries) are determined under the traditional “entire fairness” review standard.

(2) *Selecting The Most Appropriate Alternative*

[... T]he fourth alternative would merit the lowest priority. Under that alternative, a violation of the disclosure requirement would render *Glassman* inapplicable and deprive the majority stockholder fiduciary of the benefit of *Glassman's* limited review and exclusive remedy. In that setting (to reiterate), the minority shareholders would be entitled to the same remedies as are available in a fiduciary duty class action challenging a long form merger.

The strongest argument favoring this approach would run as follows: under *Glassman*, full disclosure of all material facts is a necessary condition for the fiduciary to enjoy *Glassman's* limited review and exclusive appraisal remedy. Therefore, a violation of that disclosure condition should deprive the fiduciary of those benefits. That argument, although unassailable in terms of logic and equity, is flawed in one highly important respect. To accept it would disregard the intent of the General Assembly [...] that in a legally valid, non-fraudulent, short form merger the minority shareholders' remedy should be limited to an appraisal. Moreover, validating such an approach would disserve the purpose of *Glassman's* disclosure requirement, which is to enable the minority stockholders to make an informed decision whether or not to seek an appraisal. A remedy that sidesteps appraisal altogether would frustrate that purpose.

Unlike this approach, the remaining three alternative remedies would give effect (albeit in varying degrees) to that legislative intent. Therefore, in the hierarchy those alternative remedies should rank above the one that abjures appraisal.

That observation brings into focus a second alternative – the “replicated appraisal” remedy that would duplicate precisely the sequence of events and requirements of the appraisal statute. Under that approach, the minority shareholders would receive a supplemental disclosure, to enable them to make an informed decision whether or not to elect an appraisal. Shareholders who elect that remedy must then make a formal demand for an appraisal, and then remit to the corporation their stock certificates and all the merger consideration they received.

This approach would place the minority shareholders in the situation they would find themselves had they received proper disclosure to begin with. The strongest argument favoring this alternative is that it would give maximum effect to the legislative intent recognized in *Glassman*. The flaw of this approach, however, is that it would effectuate that legislative intent at an unacceptable cost measured in terms of practicality of application and fairness to the minority. In *Gilliland*, the Court of Chancery so recognized, implicitly acknowledging the impracticality of such an approach by refusing to order a “replicated appraisal” remedy:

The opt-in procedures to be followed, however, will not be as stringent as those under the statute. For example, the court will not require beneficial or “street name” owners to “demand” quasi-appraisal through their record holder. The court is concerned that, given the substantial passage of time since the merger, it would be difficult for stockholders to secure the cooperation of the former record holders or nominees needed to perfect demand in accordance with the statute. Instead, stockholders seeking to opt-in will need to provide only proof of beneficial ownership of [their] shares on the merger date.

The *Gilliland* court also recognized (again, implicitly) that it would be unfair to require shareholders who desire an appraisal to remit the entire merger consideration they received *to the corporation*, as would occur in a replicated appraisal. Instead, the court required only that “those stockholders who choose to participate in the action to pay *into escrow a portion* of the merger consideration they have already received.” The *Gilliland* court thereby acknowledged the unfairness of requiring the minority stockholders to bear the risk of the corporation's creditworthiness, which would result from their having to pay back a portion of the merger proceeds to the company. Instead, the court ordered that the proceeds be placed into an escrow account, with the escrowed funds representing only a portion of the merger consideration the minority actually received.

[...] A replicated appraisal remedy would also give controlling shareholders little incentive to observe their disclosure duty in future cases, since the cost of the remedy to the controllers would be negligible. Both in *Gilliland* and in this case the Court of Chancery eschewed that approach, concluding instead that the appropriate remedy should be a “quasi appraisal.” Both parties agree with that conclusion, and so do we.

That requires us to choose between the two dueling forms of quasi-appraisal advocated by the parties on this appeal. Both forms would entitle the minority stockholders to supplemental disclosure enabling them to make an informed decision whether to participate in the lawsuit or to retain the merger proceeds. Both forms would entitle those who elect to participate to seek a recovery of the difference between the fair value of their shares and the merger consideration they received, without having to establish the controlling shareholders' personal liability for breach of fiduciary duty. The difference between the two quasi-appraisal approaches is that under the defendants' approach (which the Court of Chancery approved), the minority shareholders who elect to participate would be required to “opt in” and to escrow a prescribed portion of the merger proceeds they received. Under the plaintiff's approach, all minority stockholders would automatically become members of the class without being required to “opt in” or to escrow any portion of the merger proceeds.

As thus narrowed, the final issue may be stated as follows: under the standard we have applied, which remedy is the more appropriate – the one that imposes the opt in and partial escrow requirements or the one that does not? Considerations of utility and fairness impel us to conclude that the latter is the more appropriate remedy for the disclosure violation that occurred here. [...]

We start with the “opt in” issue. The approach adopted by the Court of Chancery requires the minority shareholders to opt in to become members of the plaintiff class. The other choice would treat those shareholders automatically as members of the class – that is, as having already opted in. Those shareholders would continue as members of the class, unless and until individual members opt out after receiving the remedial supplemental disclosure and the Rule 23 notice of class action informing them of their opt out right. From the minority's standpoint, the first alternative is potentially more burdensome than the second, because shareholders that fail [to opt

in] forfeit the opportunity to seek an appraisal recovery. On the other hand, structuring the remedy as an “opt out” class action avoids that risk of forfeiture, and thus benefits the minority shareholders. To the corporation, however, neither alternative is more burdensome than the other. Under either alternative the company will know at a relatively early stage which shareholders are (and are not) members of the class.

Given these choices, it is self evident which alternative is optimal. As between an opt in requirement that would potentially burden shareholders desiring to seek an appraisal recovery but would impose no burden on the corporation, and an opt out requirement that would impose a lesser burden on the shareholders but again no burden on the corporation, the latter alternative is superior and is the remedy that the trial court should have ordered.

That leaves the requirement that the minority shareholders electing to participate in the quasi-appraisal must escrow a portion of the merger proceeds that they received. [...] The defendants-appellees argue that it is fair and equitable to require the minority shareholders to escrow some portion of the merger proceeds. Otherwise (defendants say), the shareholders would have it both ways: they could retain the merger proceeds they received and at the same time litigate to recover a higher amount—a dual benefit they would not have in an actual appraisal. It is true that the minority shareholders would enjoy that “dual benefit.” But, does that make it inequitable from the fiduciary's standpoint? We think not. No positive rule of law cited to us requires replicating the burdens imposed in an actual statutory appraisal. Indeed, our law allows the minority to enjoy that dual benefit in the related setting of a class action challenging a long form merger on fiduciary duty grounds. In that setting the shareholder class members may retain the merger proceeds and simultaneously pursue the class action remedy. [...]

[...]

In cases where the corporation does not comply with the disclosure requirement mandated by *Glassman*, the quasi-appraisal remedy that operates in the fairest and most balanced way and that best effectuates the legislative intent underlying Section 253, is the one that does not require the minority shareholders seeking a recovery of fair value to escrow a portion of the merger proceeds they received. We hold, for these reasons, that the quasi-appraisal remedy ordered by the Court of Chancery was legally erroneous in the circumstances presented here.

* * *

To summarize: where there is a breach of the duty of disclosure in a short form merger, the *Gilliland* approach does not appropriately balance the equities. If only a technical and non-prejudicial violation of 8 *Del. C.* § 253 had occurred, the result might be different. In some circumstances, for example, where stockholders receive an incomplete copy of the appraisal statute with their notice of merger, the *Gilliland* remedy might arguably be supportable. But the majority stockholder's duty of disclosure provides important protection for minority stockholders being cashed out in a short form merger. This protection – the quasi-appraisal remedy for a violation of that fiduciary disclosure obligation – should not be restricted by opt in or escrow requirements. [...]