EFiled: Oct 08 2012 10:50PM EDT
Filing ID 46856297
Case Number 470,2012

IN THE SUPREME COURT OF THE STATE OF DELAWARE

THE ORCHARD ENTERPRISES, INC., Respondent Below, Appellant, v. MERLIN PARTNERS LP Petitioner Below, Appellee. -and- THE ORCHARD ENTERPRISES, INC., Respondent Below, Appellant, v. MATTHEW GIFFUNI, CHRISTOPHER YEAGLEY and QUADRE INVESTMENTS LP, Petitioners Below, Appellees. IN RE: APPRAISAL OF THE ORCHARD ENTERPRISES, INC.	§	No. 470, 2012 On Appeal From The Court of Chancery of the State of Delaware, Consolidated C.A. No. 5713-CS

OPENING BRIEF OF APPELLANT THE ORCHARD ENTERPRISES, INC.

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NATURE OF PROCEEDINGS

Appellant The Orchard Enterprises, Inc. ("Orchard") appeals from the July 26, 2012 Final Order and Judgment of the Court of Chancery (Exhibit A hereto) and the July 18, 2012 Memorandum Opinion of the Court of Chancery ("Op." (Exhibit B hereto)), rendered in an appraisal proceeding pursuant to 8 *Del. C.* § 262. The Court of Chancery found that the per share value of the common stock of Orchard was $4.67 a share on July 29, 2010, the day of a going-private merger for the company. That incorrect per share amount was driven by the trial court's holding that, in appraising the value of the common stock of this small cap digital music distribution company, it could not account in any way for the $25,000,000 invested by the preferred stockholders or the concomitant liability of the company to the preferred stockholders. That is the sole issue on this appeal: does Orchard's obligation to the preferred stockholders, given as consideration for the preferred's infusing most of the concern's capital and indisputably creating the value in the company, get recognized in appraising the value of the common stock, when that obligation is far and away the most important consideration in the market's value of the company and the common shares? The Court of Chancery answered no, placing no value on this liability.

The Court of Chancery's decision on this point may surprise a large segment of the investing community. The litigation preference held by Orchard's preferred stockholders is a common protection for venture capital investments in small start-up companies. In fact, the National Venture Capital Association recommends precisely such

protection for investors in their model form documents. The preferred stockholders gave full value for this protection.

The appeal concerns whether such liquidation preferences, or analogous debt-like liabilities, are to be taken into account when the Court of Chancery makes an appraisal determination under 8 *Del. C.* § 262 ("Section 262"). In particular, is such a preference to be accorded *any* weight when appraising the value of the common stock before a going private merger? While in such a merger the liquidation preference technically may still exist following the merger, in truth following the merger the preference is now merely a paper debt from the preferred stockholder to itself, and by the merger the common stock is in practical effect freed from the single most important market consideration concerning the price of the common stock that existed before the merger. This case thus presents the Court with a not uncommon factual scenario that nonetheless does not fit easily into the constructs of existing precedent.

The undisputed economic and market reality is that such a preference, in the amount of $25,000,000, overhangs the value of the common stock. Also undisputed was testimony that the market accounted for the preference fully in valuing the common shares; the common stock never traded above $2.00 a share in the year before the merger. Offers to purchase the company recognized the necessity to pay the preference, and as a result would have paid the common stockholders far less than the going private merger in question here.

The Court of Chancery acknowledged that Orchard's position was "grounded in market realities," but nonetheless opined that *Cavalier*

Oil Corp. v. Harnett, 564 A.2d 1137 (Del. 1989), required that the court give no weight to the liquidation preference given the *Cavalier Oil* requirement to value the company as a going concern. Appellant believes the trial court misapprehends the holding of *Cavalier Oil*. Under 8 *Del. C.* § 262, the court's task 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.*" 8 *Del. C.* § 262(h) (emphasis added). This determination shall take into account all non-speculative information bearing on the value of the shares at issue in an appraisal. *Weinberger v. UOP*, 457 A.2d 701, 713 (Del. 1983). The appraisal determines the economic value of the company based on its contractual obligations, including its contractual obligations to preferred stockholders. *Id.* The appraised value is not supposed to be affected by the form of the transaction that gives rise to the appraisal rights. Yet that is exactly what the decision of the trial court inadvertently does here.

Nothing in Section 262 or this Court's jurisprudence requires a court to ignore "market realities" and, as a result, appraise appellees' common stock at a significantly higher price than that which the market would bear. Otherwise, the appraisal procedures may result in a windfall for the common stockholders, as happened here. Orchard respectfully requests the Court to reverse the order of the court below and remand for a determination of common share value that includes *all* of the economic realities and liabilities of Orchard.

SUMMARY OF ARGUMENT

1. The Series A preferred stock's liquidation preference right was the central market reality for Orchard and its common stock on July 29, 2010. "*All relevant factors* are to be considered in determining fair value of shares subject to appraisal." *Cavalier Oil*, 564 A.2d at 1143-44 (emphasis added). The preferred stock's "specific, non-speculative contractual right was inarguably an important economic factor bearing on the valuation of the Preferred Stock as of the Merger date that any reasonable investor or market participant would have taken into account." *Shiftan v. Morgan Joseph Holdings, Inc.*, 2012 WL 120196, at **9-10 (Del. Ch. 2012); 8 *Del. C.* § 262(h).

2. The preferred stockholders' right to the liquidation preference before the common stockholders received anything was specific in amount, not hypothetical, and a matter of contract. No value above the stock trading price could come to the common stock without payment of this preference first to the preferred stockholders. The liquidation preference is inarguably an "element of value" for the Series A Preferred stockholders "that existed before the accomplishment or expectation of the merger." 8 *Del. C.* § 262(h).

3. The Court of Chancery's failure to account for the liquidation preference effectively relieved the common stockholders of that liability. Through the decision below the common stockholders thereby gained an element of value from the completion of the transaction. The court thereby "determined the fair value of the shares" *inclusive* of an "element of value arising from the

accomplishment or expectation of the merger or consolidation," in violation of 8 Del. C. § 262(h).

4. The Court of Chancery concluded that the preferred stockholders waived the right to have the single biggest liability of the company counted in the valuation of the common stock because the merger did not involve the actual payment of that liability. However, the determination of the economic value of the company cannot be driven by the form of the transaction.

5. When appraising stock the Court of Chancery must take into account "proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court." *Weinberger v. UOP*, 457 A.2d 701, 713 (Del. 1983). The financial community, in valuing the Series A Preferred Stock pursuant to generally accepted techniques, considers it highly relevant that the stock has a change-of-control and liquidation preference, at the top of the capital structure, ensuring that the first $24,990,000 of value would always go to the Series A Preferred, in a company worth well more than that amount by anyone's estimate.

6. Allocating value to the liquidation preference is not the equivalent of recognizing a control premium or a minority discount. A liquidation preference is an economic right, not a control right, and there is no "windfall" to the preferreds from its recognition.

7. The Court of Chancery bestowed a windfall on the common stockholders of Orchard that they never could have realized in any other time or place.

STATEMENT OF FACTS

I. The Parties

Orchard, an independent music and video distribution company, is a Delaware corporation. It is the surviving corporation in the merger of Orchard Merger Sub, Inc., a wholly owned subsidiary of Dimensional Associates, LLC ("Dimensional"), with and into The Orchard Enterprises, Inc. pursuant to 8 *Del. C.* § 251, on July 29, 2010. Op. at 1. Orchard controls and distributes music and audio recordings, video programming and other materials through digital stores such as Amazon, eMusic and iTunes, and mobile carriers including Verizon. A414; A122. Appellees owned in the aggregate 604,122 shares of the Common Stock of Orchard on the date of the Merger. Op. at 1.

II. The Capital Structure of Orchard

Orchard has two classes of outstanding stock, common and Series A Convertible Preferred Stock. At the time of the merger, there were 6,378,252 shares of common stock issued and outstanding, which were publicly traded on the NASDAQ Stock Market. A411-412. On March 15, 2010, the last trading day before the announcement of the merger, the common stock closed at $1.66 per share. A435.

The preferred stock is Orchard's most senior class of securities. On the day of the merger, July 29, 2010, 448,707 shares of preferred stock were issued and outstanding. A411. Dimensional and its affiliates held 2,738,327 shares of common stock and 446,918 shares of preferred stock, representing approximately 54% of the voting power of the outstanding shares. A364.

III. The Transaction

A. The Dimensional Proposal

Before Dimensional first invested in 2003, Orchard was a small, privately held company, with about $300,000 in annual revenues. A782 at 223:7-24. Over the course of the next six years Dimensional invested $25,000,000 in Orchard. A782-783 at 223:17-225:1. That investment accounted for the bulk of Orchard's capitalization and created Orchard's value that existed on July 29, 2010. In return for the core $25 million investment, Dimensional and the other preferred stockholders received a preference, set forth in the Certificate of Designations of Series A Convertible Preferred Stock. Issued in 2007, the Certificate of Designations provided that the preferred stockholders were entitled to the first payment of $24,893,333 upon a merger, sale or other "Change of Control Event," or upon the voluntary or involuntary liquidation, dissolution, sale of assets or winding up of Orchard -- in other words, before any other monies were taken out of Orchard by anyone, including the common stockholders.[1] A20-28. Without that protection Dimensional would not have invested. A783 at 228:3-13.

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[1] Pursuant to that Certificate of Designations, the Series A Preferred Stock was entitled to a liquidation preference. The preference had a value of the greater of (1) $55.70 per share (equivalent to $16.72 per share of Common Stock) plus any unpaid accrued dividends, or (2) the per share amount that would be payable if the Preferred Stock had been converted into Common Stock immediately prior to the liquidation event plus unpaid accrued dividends. A21-a—A21-c at § 2.

Despite Dimensional's investments, by 2009 (and indeed continuing until the merger) Orchard was consuming large quantities of capital, had never generated positive EBITDA, and despite extensive efforts had been unable to attract a buyer. A784 at 232:11-21. The economy was in recession. It was imperative to get additional capital into the company. An extensive effort to find other sources of financing, whether by investment or purchase, produced none. A364-366; A784-785 at 230:5-233:9, A786 at 238:13-240:1, A788-789 at 247:16-251:24. In this effort Dimensional was a "willing seller," requiring only that it recoup its $25 million investment protected by the preference. A785 at 233:5-11, A786 at 237:3-238:4; A378; A113-115; A29-112.

In October 2009, with the trading price for common shares at about $1.50, Dimensional informed Orchard that it was considering making a proposal to buy the outstanding shares of capital stock of the company that it did not already own. A358, A364, A366; A785 at 233:12-234:13. In response to Dimensional's offer, Orchard's board of directors formed a special committee, comprised of three independent members of the board, to review and evaluate any offer made by Dimensional. A358, A364, A366. No member of the special committee was employed by or affiliated with Orchard (except in his capacity as a director) or had any economic interest in Dimensional or its affiliates. *Id.* The special committee engaged Fesnak & Associates, LLP ("Fesnak") as its financial advisor. A368. Shortly thereafter, Dimensional made an initial offer to purchase the common stock for $1.68 per share. Extensive negotiations followed. A366-374. On January 13, 2010, Dimensional increased its offer to $2.05 per share

and agreed to shareholder protections, including a "majority of the minority vote" condition and a "go-shop" provision. A372.

B. Fairness Opinion of Fesnak and Associates, LLP

Fesnak analyzed the proposed transaction and rendered a fairness opinion. Fesnak's analyses included a comparable public company analysis, a selected relevant transactions analysis and a discounted cash flow analysis, and also was based on consideration of the market value of the common shares and the immutable $25,000,000 liquidation preference overhang. A273-305. Relying in part on the Fesnak fairness opinion, the special committee determined that the merger was substantively and procedurally fair, and in the best interests of Orchard's unaffiliated stockholders. A375. Among other things, the special committee concluded that the merger was more favorable to Orchard's unaffiliated stockholders than any strategic alternative, the merger consideration was likely the highest price reasonably attainable for Orchard's stockholders, and a credible competing offer was unlikely. A377-378, 381. The special committee also relied on the existence of protective provisions in the merger agreement, including the "go-shop" and termination provisions, the closing conditions and the required majority of the minority vote. A378-379. The board in turn unanimously approved the merger. A377-378.

C. The "Go-Shop"

Upon execution of the merger agreement, the special committee engaged Craig-Hallum Capital Group LLC ("Craig-Hallum") to conduct the "go-shop" process. Orchard was authorized to initiate, solicit and encourage alternative acquisition proposals from third parties and to

discuss and negotiate any acquisition proposals. A252-253 at § 7.3. The go-shop continued through April 21, 2010. A308-309. Craig-Hallum contacted 35 potentially interested parties, including 23 strategic parties operating in Orchard's industry and 12 potential financial buyers who invest in companies in Orchard's industry. A375. Four potentially interested parties entered into non-disclosure agreements with the company and were provided access to its electronic data room. *Id.* One of the financial buyers conducted face-to-face due diligence meetings with Orchard's management. *Id.* None of these discussions, however, produced an offer for an alternative transaction to acquire Orchard. *Id.*

The go-shop period expired on April 22, 2010 and the company ceased actively soliciting offers. Nonetheless, the merger agreement authorized Orchard to negotiate with anybody making a bona fide acquisition proposal in writing that could lead to a superior proposal. A252-253 at § 7.3. No such proposals were received by the special committee. One of only two proposals, which the expert for the appellees relied upon as instructive (the "Bidder B" offer), accorded a $25 million value to the preferred stock and offered less per common share than the merger consideration. A779-780 at 212:5-214:4; A529-533.

D. Approval by Orchard's Stockholders

Following the recommendation of Orchard's board of directors and the conclusion of the go-shop period, on July 29, 2010 the company held an annual meeting of stockholders. The majority of Orchard's

outstanding shares *and* the majority of the shares not held by Dimensional and its affiliates both approved the merger.

E. Amendment to the Certificate of Designations

When the merger was contemplated the Certificate of Designations for the Series A Preferred Stock precluded the company from effecting any transaction that constituted a Change of Control Event, with only two authorized exceptions. The first exception was for transactions that constituted a true liquidation of Orchard and the second exception was for change of control transactions with an unrelated third party. A21-b – A21-c at § 2(c). Under both exceptions, the holders of preferred stock would realize their full liquidation preference. All other Change of Control Events were prohibited. *Id.*

The Merger at issue was a "Change of Control Event" because "the holders of capital stock of the Corporation immediately prior to such merger" would not "continue to hold immediately following the merger or consolidation in approximately the same proportion as such shares were held immediately prior to such merger or consolidation." A21-c at § 2(c)(A).[2] Accordingly the company sought the approval of the stockholders to amend the Certificate of Designations. The amended

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[2] The pre-merger and post-merger stock ownership of Orchard is not in dispute. Immediately prior to the merger, Dimensional owned 42.48% of the common stock and unrelated stockholders held 57.52%. A721 at ¶8. Post-merger, Dimensional owned almost 100% of the common stock. *Id.* at ¶9. These amounts are not "approximately the same." Similarly Dimensional owned approximately 53% of the outstanding voting power and economic interest of Orchard's capital stock immediately prior to the Merger, while it held over 99% of the voting power and economic interest of the Corporation's capital stock immediately following the Merger. *Id.* at ¶¶ 10, 11.

language permitted Orchard to enter into a Change of Control Event "upon the prior vote or written consent of the holders of at least a majority of the then outstanding shares of Series A Preferred Stock." A534-536. This amendment, which was consented to by the preferred stockholders as a quid pro quo for the merger, allowed the transaction to take place, when otherwise it would have been barred. A789-790 at 252:1-253:23.

F. The Proceedings Below

On July 22, 2010, prior to the consummation of the merger, appellee Merlin Partners LP caused Cede & Co. to demand appraisal on its behalf of the 302,649 common shares beneficially owned by it and held of record by Cede & Co, and appellees Quadre Investments, L.P. and Matthew Giffuni caused Cede & Co to demand appraisal on their behalf of 141,319 common shares they beneficially owned. A719-720 at ¶¶1-3. On July 27, 2010, appellee Christopher Yeagley caused Cede & Co. to demand appraisal of his 160,154 common shares. A720 at ¶4. The appellees continued to hold their shares through the merger date.

On August 12, 2010, Merlin Partners petitioned for appraisal. Quadre, Giffuni, and Yeagley followed suit on September 9, 2010. The petitions were consolidated for all purposes on July 8, 2011.

Expert reports were provided by both sides. A copy of the report of Orchard's expert, Robert Fesnak, is included in the appendix at A624-683. A trial was held on April 2-3, 2012, during which Mr. Fesnak and the Chairman of the Executive Committee of Orchard, Daniel Stein, testified. A793-822; A782-793. Timothy Meinhart testified as an expert for the appellees. A727-782.

The Court of Chancery issued its opinion on July 18, 2012, holding that under *Cavalier Oil Corp.*, the valuation of the preferred stock must be only on an as-converted basis, and that the court could not take into account the $25 million liquidation preference.[3] Judgment was entered on July 26, 2012 appraising appellees' shares at $4.67 per share. Orchard appeals from that judgment to the extent that it fails to account for $25 million liquidation preference, which should have been considered in appraising appellees' shares.

[3] The Court of Chancery also disagreed with the valuation methodology employed by Orchard's accountants. While Appellant believes that determination was in error, it does not challenge that finding on this appeal.

ARGUMENT

I. QUESTION PRESENTED

Should the Court's appraisal of the fair value of appellees' shares of common stock as of the day of the merger take into account the $25 million liquidation preference held by the preferred stockholders and given in return for a $25 million investment, where the market valued the company and its common stock fully accounting for the $25 million liquidation preference, and where failing to account for that $25 million liquidation preference effectively grants appellees a per-share price for their stock that they never could have received in any venue other than an appraisal proceeding?

The pages of the appendix where Orchard preserved this question in the court below are: A834-836; A846-857; A934 at 10-16; A937-945 at 53:1-61:1; A787 at 281:19-284:23; A816 at 357:16-358:17; A785 at 233:12-234:13; A786 at 237:3-238:4; A791-792 at 260:1-261:14; A689-693; A701; A702.

II. STANDARD AND SCOPE OF REVIEW

The Court's "review is *de novo* to the extent a trial court decision implicates the statutory construction of DGCL § 262." *Golden Telecom, Inc. v. Global GT LP*, 11 A.3d 214, 216-17 (Del. 2010); *M.P.M. Enters., Inc. v. Gilbert*, 731 A.2d 790, 795 (Del. 1999).

Appellant notes that the Court utilizes an abuse of discretion standard when reviewing factual findings in a statutory appraisal proceeding. *Id.* The factual findings below are not the basis for this appeal, however. In particular, the parties do not dispute the terms of the preference or its amendment, and the court recognized

that there is "some market force" to the evidence (undisputed) presented by Orchard about the market's pre-merger valuation of the preference and common stock. Op. at 17. After all, Orchard's position that "no third-party investor or market participant would value Orchard without taking into account this overhanging liability, and Dimensional would never approve a transaction with a third party in which it did not receive its litigation preference" (*id.*), was not disputed at trial or by the Court of Chancery.

Thus the contested issue on this appeal is whether the preference and the market realities should have been included in appraising the value of the company's common stock as of the day of the merger. The Court of Chancery held that the appraisal statute forbids it from doing so. The Court should review this purely legal question *de novo*.

III. MERITS OF ARGUMENT

A. The Preferred Stock's Specific, Non-Speculative Right Was Inarguably an Important Economic Element Bearing on the Value of the Common Stock

The Series A Preferred stockholders had the fixed contractual right to receive the first $25 million of value from the company, whether by sale, dissolution, sale of assets, merger, liquidation, or otherwise. A21-a – A21-c at § 2(a), 2(c). In the capital structure of Orchard on July 29, 2010, the claims of the holders of senior preferred securities came before those of the common stockholders. *Id.*; A783 at 225:5-23. Orchard's Certificate of Designations entitled the Series A preferred stockholders to the liquidation preference before any sale could be made of the company. A21-b – A21-c at § 2(c).

The preferred stockholders had two core, bargained-for benefits: the preference in section 2 of the Certificate of Designations, and the conversion rights in section 4. A21-26 at §§ 2(a), 2(c), 4. The Court of Chancery's valuation of Orchard accords a value to the conversion right, but none to the preference right. A585-587; A778-779 at 208:14-209:5, 211:8-23.

The market valued the company in exactly the opposite manner, however, fully accounting for the $25 million preference right. A797 at 283:24-284:23, A779 at 211:8-23. The special committee of the board and its advisors also valued the preferred stock at the $25 million liquidation preference value. A306-307 at § 8; A794-795 at 272:19-274:6. The company's 10-K reflected the full amount on its balance sheet. A168. Even the "Bidder B" offer, relied on by appellees' expert, accorded a $25 million value to the preferred stock. A779-780 at 212:5-214:4; A529-533.

The preferred stockholders bargained for this pre-merger liquidation right and invested $25 million in reliance on it. A782-783 at 224:5-225:23, 227:4-228:13; A779 at 210:24-211:2. As the certificate of designations provided, the Series A preferred understood and relied upon the fact that they would receive their liquidation preference before any sale of the company. *Id; cf.* A21-b – A21-c at §2(c); A534-536. In recognition of that preference, the SEC required that the $25 million preference be shown on the face of the audited financial statements, not in the notes. A795 at 274:16-

276:10; 480-10-S99 SEC Materials and SEC Staff Guidance at S99-3A.[4] Even the merger was barred by the protections for the preferred stockholders in the certificate of designations, which had to be amended to permit this change of control transaction. A534-536; A356; A516; A789-790 at 252:1-253:23.

The preferred stockholders' preference overhung the common stock and there was no way for the common to receive any greater value than the low trading prices in a sporadic market. A784 at 229:3-16; A779 at 210:15-19. The share prices in the trading market reflected the preferreds' $25 million overhang: the shares of Orchard never traded above $2.00 in the year preceding the Merger. A304. Nobody would make a credible bid for Orchard, despite two extensive solicitation processes, in significant part because the liquidation preference had to be paid prior to completing a transaction. A378; A784-785 at 230:5-233:4.

The trial court acknowledged "that there is some market force" to Orchard's argument "that there was an inarguable $25 million liability overhanging the [c]ommon [s]tock'" on the day of the Going Private merger that "reduced the value of the [c]ommon [s]tock." Op. at 17 (quoting Resp. Post-Tr. Ans. Br. at 18 (A851)).[5] After all, it was

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[4] A Compendium of Authorities Cited in the Opening Brief of Appellant The Orchard Enterprises, Inc. is being filed contemporaneously herewith.

[5] The trial court erroneously suggested this argument first had been raised post-trial, but the argument occupied the first five pages of Orchard's Pre-Trial Answering Brief, and was the subject of significant trial testimony. A689-693; A701-702; *see, e.g.*, A797 at

undisputed at trial that "no third-party investor or market participant would value Orchard without taking into account this overhanging liability, and Dimensional would never approve a transaction with a third party in which it did not receive its litigation preference." Op. at 17. But the Court of Chancery concluded that *Cavalier Oil* precluded it from taking this element of value into account.

To the contrary, *Cavalier Oil* instructs that "'*all relevant factors* are to be considered in determining fair value of shares subject to appraisal." 564 A.2d at 1143 (quoting *Weinberger*, 457 A.2d at 713(emphasis added)). *Cavalier Oil* discussed with approbation the Court's opinion in *Tri-Continental Corp. v. Battye*, 74 A.2d 71 (Del. 1950), in which the Court specifically considered the market value of the stock. 564 A.2d at 1144-45. *Cavalier Oil* recognizes the propriety of taking into account "objective market data" when, as here, it is available. *Id.* at 1145.

The task here is to determine the value of the common stock on the day of the merger. On that day, there was a $25,000,000 liability overhanging that common stock which indisputably was a "market reality." A783 at 228:14-19. By disregarding that liability, the Court of Chancery granted appellees greater than market value for their shares.

282:17-283:20, A816 at 357:16-358:17; A786 at 237:14-238:4; A791-792 at 260:1-261:14.

The court concluded that "[a]llocating the value of the liquidation preference to Orchard's preferred stockholders would be tantamount to valuing the company on a liquidation basis or presuming a sale of the company, because it is only in those circumstances that the preference would be triggered," and that such an analysis impermissibly required the Court to consider "post-merger events or other possible business combinations" in violation of *Cavalier Oil*. Op. at 18. But accounting for Orchard's liability to Dimensional and the other preferred stockholders -- a specific, non-speculative liability -- does not value the company at its liquidation value rather than as a going concern. It merely takes into account how the market valued the going concern, based on objective market data, as expressly sanctioned by *Cavalier Oil*, 564 A.2d at 1145, discussing *Tri-Continental*, 74 A.2d at 72-73.

While the preference would certainly be central to a liquidation valuation, that does not make the preference irrelevant to a going-concern analysis. The Series A Preferred stock's "specific, non-speculative contractual right was inarguably an important economic factor bearing on the valuation of the Preferred Stock as of the Merger date that any reasonable investor or market participant would have taken into account." *Shiftan*, 2012 WL 120196 at **9-10; *cf. In re Appraisal of Metromedia Int'l Group, Inc.*, 971 A.2d 893, 900 (Del. Ch. 2009); 8 *Del. C.* § 262(h). The market factors affecting a company and its stock must be considered in an appraisal proceeding:

> Thus, market value, asset value, dividends, earning prospects, the nature of the enterprise and any other facts which were known or which

> could be ascertained as of the date of the merger and which throw any light on *future prospects* of the merged corporation are not only pertinent to an inquiry as to the value of the dissenting stockholder's interest, but *must be considered* by the agency fixing the value.

Weinberger, 457 A.2d at 713(emphasis added in original) (*quoting Tri-Continental*, 74 A.2d at 72).

B. The Preferreds' Right Was Neither Hypothetical Nor Speculative.

In the Court of Chancery's view, *Cavalier Oil* excluded consideration of the liquidation preference because "the preferred stock remains outstanding and the liquidation preference is due if one of the triggering events occurs in the future." Op. at 14. But this, too, ignores the economic reality that after the Merger, which could not have happened without the preferred's consent, the liquidation preference was transformed from a meaningful, blocking $25,000,000 right to a vestigial obligation by the preferred stockholders to pay $25,000,000 to themselves, if they so elected. Before the merger, just "like the claims of debt holders, the claims of the holders of senior preferred securities come before those of the common stockholders" because "that is what the relevant corporate contract requires." *Shiftan*, 2012 WL 120196, at *10 n.41.

To value the preferred stock the court had to assess the value-adding claims of the preferred stockholders, including the preference contained in the stock's relevant corporate contract. *Id.* The court was not relieved of that obligation simply because the preferred stockholders did not incorporate the triggering of their obligation into the terms of the merger transactions. The preferred

stockholders' right to the liquidation preference before the common stockholders received anything was specific in amount, not hypothetical, and a matter of contract not speculation. The amount to be paid to the preferred stock was fixed and determinable. A797 at 282:7-12. The liquidation preference had to be paid first in any transaction, liquidation, sale of assets or other event. No value could come to the common stock outside the market price for their shares without payment of this preference first to the preferred stockholders. *Cf. Gale v. Bershad*, 1998 WL 117922, at *6 (Del. Ch.) (denying motion to dismiss breach of contract claim based on corporation's failure to comply with redemption provision).

Relying on the prior decisions of the Court of Chancery in *Shiftan* and *Metromedia*, the court below concluded that *no* value should be accorded this right because the merger did not trigger the preference payment. Op. at 15-16. But in *Metromedia* the court did not value the liquidation preference because there were "various exit strategies available to [the private investor] that would not require redemption of the preferred shares" and therefore would not trigger the liquidation preference. 971 A.2d at 905. No such exit strategies were available to the holders of Orchard's common stock. *Shiftan,* meanwhile, augers in favor of recognizing the full value of the liquidation preference here. After all, the amount of the preference is fixed, not contingent on future events; the events triggering the preference here give "logical economic reasons for the senior preferred equity holders" to get the full value of their preference; and as with the redemption right in *Shiftan*, this case is

distinguishable "from cases in which this court has refused to consider speculative possibilities in rendering an appraisal or preferred stockholders were contractually told how their shares would be treated in the event of a merger and that their redemption rights would be extinguished on certain terms." 2012 WL 120196, at **2-3. As in *Shiftan*, "there is no question about the probability that an event triggering" the liquidation preference would have taken place. *Id.* at *9 n.37.

The preferred stockholders had bargained for and given full consideration for an absolute blocking right in all but two specific situations. The board of directors and special committee recognized this contractual fact of life when it discussed the "Bidder B" negotiations in the proxy statement. A370. This blocking right meant that the Certificate of Designations had to be amended to permit the Merger to occur. A21-b – A21-c at §2(c); A356; A516; A534-536. As amended, the certificate authorized the merger as "provided upon the prior vote or written consent of the holders of at least a majority of the then outstanding Series A preferred stockholders." The $2.05 per share common stock price paid in the merger accordingly accounted for the liquidation preference. A273-305; A343-528.

The preferreds' blocking right sets this case apart from the "harder case" posited in *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435 (Del. Ch. 2010). The *LC Capital* court observed that "the only thing rendering the future dividend stream in the hard case a non-speculative future source of income would be the judicial holding that preferred stockholders, *who did not bargain for the right to*

block a merger that would result in the end of the corporation and therefore their future dividend stream, have to be compensated for the very stream that they did not procure a contractual right to force to continue." *Id.* at n. 56 (emphasis added).

Here, by contrast, the preferred stock's liquidation preference is made non-speculative by the fact that the certificate of designations requires payment of the liquidation preference upon either a company liquidation or a Change of Control event with an unrelated third party. In any other Change of Control event, the consent of the preferreds is required, the price of which — as was the case here — would always be the liquidation preference. A784-785 at 232:11-234:13.

The Court of Chancery's opinion does not address the impact of Dimensional's blocking right on the valuation. Instead the court imposed a bright-line test, concluding that the liquidation preference cannot be considered merely because it had not been triggered. The task in this proceeding is to value the common stock on the day of the merger. A trigger is not required by the statute or this Court's precedent. What is required is a fair appraisal of the worth of the stock in light of the contractual rights of the Series A preferreds and the economic realities of the company. By excluding the liquidation preference for lack of a "trigger," the court below elevated form over substance.

> *Only the speculative elements of value that may arise from the "accomplishment or expectation" of the merger are excluded. We take this to be a very narrow exception to the appraisal process,* designed to eliminate use of *pro forma* data and

> projections of a speculative variety relating to the completion of a merger. But elements of future value, including *the nature of the enterprise*, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered.

Cede & Co. v. Technicolor, Inc., 684 A.2d 289, 297 (Del. 1996) (emphasis in original) (*quoting Weinberger*, 457 A.2d at 713).

The Court of Chancery seeks to expand this "very narrow exception" beyond recognition. The opinion below, if affirmed, would preclude a court from evaluating as a factor in the appraisal an event, like the $25 million debt overhang here, that exists both before and after the merger, and which is certain to occur, and which is the single most salient factor in the market's assessment of the shares. The liquidation preference was not "a speculative effect of the merger." *Cede*, 684 A.2d at 297. It should be accounted for in appraising the value of the common shares.

C. To Not Account For The Liquidation Preference Is To Value The Orchard On A Post-Merger Basis

The Court's task 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 non-speculative information bearing on the value of the shares at issue in an appraisal. *Weinberger*, 457 A.2d at 713; 8 *Del. C.* § 262(h). Among other things, the court must consider the company's contractual obligations, including its contractual obligations to its preferred stockholders. *Id.* By not accounting for Orchard's contractual liquidation preference liability, the trial court relieved the common stockholders

of that liability. The court thereby "determined the fair value of the shares" *inclusive* of an "element of value arising from the accomplishment or expectation of the merger or consolidation," an action forbidden by 8 *Del. C.* § 262(h). Through the Court of Chancery's decision the common stockholders thereby gained an element of value from the completion of the transaction, because the requirement on the company to pay the $25 million liability was waived by the preferreds, by an amendment to the certificate of designations, agreed to for the sole purpose of permitting the going-private merger to take place.

The court below recognized the overhang and that the common were being relieved of it, but addressed this consequence only with the assertion that "the appraisal remedy exists to a large extent to address the potential that majority power such as Dimensional wielded will be abused at the expense of the minority." Op. at 17. But while the appraisal remedy exists in part to protect stockholders who believe merger consideration is too low, including in scenarios of majority overreach, a Section 262 appraisal itself is supposed to be a neutral proceeding. "Since neither party is entitled to any preference or presumption in this proceeding, the underlying assumptions that drive these valuations must be tested equally to ensure that all relevant facts were properly and reasonably considered." *Gilbert v. MPM Enters., Inc.*, 709 A.2d 663, 667 (Del. Ch. 2009) (*citing Pinson v. Campbell-Taggart, Inc.*, 1989 WL 17438, at *17 (Del. Ch. Feb. 28, 1989)). Therefore all liabilities of the

company, however denominated, must be considered, and all economic realities of the company and its stock taken into account.

When *Cavalier Oil* cautioned against applying a minority discount, the Court was emphasizing that the objective of a Section 262 appraisal is "to value the *corporation* itself, as distinguished from a specific fraction of its *shares* as they may exist in the hands of a particular shareholder." 564 A.2d at 1144 (emphasis in original). Orchard is not seeking to alter the value of any shares based on who owned them; it is merely seeking to have the corporation's obligations to all of the preferred stockholders fairly accounted for when valuing all of the common shares.

Instead of doing so, the court below effectively distinguished the appellees' shares at the expense of the preferred stock and required the preferred stockholders to share the liquidation preference with the common. This places the common on par with the preferred and violates the Certificate of Designations. Affirming the Court of Chancery's holding would mean accepting the proposition that a company with senior securities in a going-private transaction has to pay the securities holders twice. First, the company would have to account for the value to the senior preferred stockholders in the merger pricing, as Orchard did here. Then, it would have to pay again to the common stockholders in an appraisal proceeding. To so hold is to sanction what Section 262(h) forbids: a valuation of their shares on the day of the merger based not on their actual value that day, but on a benefit to them from the accomplishment of the merger transaction.

D. The Determination of the Economic Value of the Company Cannot be Driven by the Form of the Merger Transaction

The Court of Chancery's opinion concludes that the preferred stockholders waived the right to have the single biggest liability of the company counted in the valuation of the common stock because the merger did not involve the actual payment of the preference to the preferred stockholders. *See* Op. at 14 ("But as of the date of the Merger, the liquidation preference had not been triggered . . ."). The court thus held that if the amendment to the certificate of designations had required the payment of the preference for the merger to occur, the preference would be counted in the appraisal; but because the amendment permitted the transaction while technically preserving the preference, it does not. Op. at 14. This is nothing more than holding that an element of value immediately prior to the merger - which the preferred stockholders, Fesnak & Associates, the company and the market all valued at $25,000,000 - is of no value in appraising the company because the merger did not expressly trigger its payment.

The determination of the economic value of the company cannot be driven by the form of the transaction. The Court determines "the fair value of the shares *exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation.*" 8 *Del. C.* § 262(h) (emphasis added). The court erroneously valued the common shares using an element of value - the non-payment of the liquidation preference - arising from the transaction itself. That the liquidation preference was not actually paid is irrelevant in valuing

the common stock on the day of the merger, as the value of this preference must be specifically allocated to the preferred stockholders prior to determining the common stock's value. This priority obligation still existed, whether paid immediately or not, and it had a priority position over the value of the common stock.

Orchard's capital structure and the formulation of its certificate of designations are not unusual. The liquidation preference contract provision at issue here is not unique to this transaction. The National Venture Capital Association, a trade association for venture capital companies, has crafted a set of model terms for venture capital transactions. Section 2 of their Model Certificate of Incorporation, entitled "Liquidation, Dissolution or Winding Up; Certain Mergers, Consolidations and Asset Sales," closely tracks the language of the liquidation preference at issue here.[6] A 2000 survey of more than 200 venture capital transactions found that "all but one of the financings" the authors reviewed "ha[d] claims that in liquidation are senior to the common stock of claims of the founders" and that, in "more than 98% of the financings," "the claims of the VCs in liquidation are typically at least as large as the original investments."[7] The Court of Chancery's opinion does not

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[6] National Venture Capital Association Model Certificate of Incorporation (last updated Sept. 2012), available at: http://www.nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136.

[7] Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, REV. OF ECON. STUD., April 2003.

properly account for these common contractual terms, and therefore may have the unintended effect of depressing venture capital investment, if venture capital firms determine their bargained-for liquidation preference provisions will be accorded no value in an appraisal proceeding. Alternatively, the Court of Chancery's opinion may have the unintended consequence of driving venture capital funded start-ups to incorporate in other jurisdictions.

E. Giving No Weight to the Liquidation Preference in Valuing the Preferred Stock Is Contrary To Generally Accepted Valuation Techniques

The market valued the preference at $25,000,000. A797 at 281:19-284:23. The Series A Preferred stockholders would never have taken less than $25,000,000 for the preference. A785 at 233:12-234:13; A786 at 237:3-238:4; A370. Expert witness Robert Fesnak, who routinely values similarly situated companies, has never seen preferred stockholders take less for such a preference or waive the right. A797 at 282:17-22; *see also* A790 at 254:20-256:16.

For this reason, the Company included the full amount of the preference on the face of its balance sheets. Indeed, the Securities and Exchange Commission requires that the full amount of such a preference be disclosed on the face of the balance sheet in form 10-Ks and 10-Qs for just that reason. A795 at 274:16-276:10; 480-10-S99 SEC Materials and SEC Staff Guidance at S99-3A.

When appraising stock the Court of Chancery may take into consideration generally accepted techniques of valuation used in the financial community. *Weinberger*, 457 A.2d at 713. The "financial community," in valuing the Series A Preferred Stock, pursuant to

"generally accepted techniques," considers it highly relevant that the stock has a change-of-control and liquidation preference, at the top of the capital structure, ensuring that the first $24,990,000 of value would always go to the Series A Preferred, in a company worth more than that amount by anyone's estimate. When companies funded by private equity with a similar preference are valued, the preference is considered in determining the allocation of the enterprise value. A797 at 282:17-283:20.

The American Institute of Certified Public Accountants agrees. With reference to enterprise value allocation, including the current-value method used here by both parties' experts below, the AICPA advises that among the economic rights enjoyed by preferred stockholders are "liquidation preferences."[8] Allocation methods, including current value, "typically consider the right" to a liquidation preference. *Id.* at 56. As the AICPA has explained:

> 114. *Preference in liquidation generally is considered one of the key differentiating factors between preferred and common stock because it gives first priority rights to preferred stockholders over any equity proceeds available to common stockholders resulting from a liquidation of the enterprise. Liquidation preference distributions are meaningful and substantive because they apply not only in the event of dissolution of the enterprise but also*

[8] American Institute of Certified Public Accountants, *AICPA Audit and Accounting Practice Aid Series: Valuation of Privately-Held-Company Equity Securities Issued As Compensation* (2004), at 54 §§ 127, 128 (cited herein as "AICPA Practice Aid"). This Practice Aid, also known as the "Cheap Stock" practice aid, provides guidance for allocating enterprise value among classes of securities and has evolved as a tool for best practices. Its valuation concepts can be applied to both public and private companies with a complex capital structure.

> *in the event of a merger, sale, change of control, or sale of substantially all assets of an enterprise*. A merger, sale, change of control, sale of substantially all assets, and dissolution are collectively referred to as a *liquidation* (which differs from a liquidity event in that a liquidity event also includes an IPO).

Id. at 102 § 114 (emphasis added).

Another authority observes that "the most common and important preference" for preferred stockholders in early stage companies "is the liquidation preference," analogizing preferred stockholding to holding debt.[9] Daniel Stein and Robert Fesnak both testified at trial that such a preference is considered a liability of the company when appraising the value of start-ups capitalized with venture capital. A797 at 282:17-283:20; A816 at 357:16-358:17; A786 at 237:14-238:4; A791-792 at 260:1-261:14.

"Generally accepted techniques of valuation used in the financial community," then, support allocating the value of the liquidation preference to the Preferred Stock. The opinion of the trial court does not address this authority. Certainly it should not be the case that the appraisal remedy grants dissenting shareholders rights greater than that which the market will bear. If that were the case, there would be no incentive for any shareholder to accept the market valuation, and the Court would be flooded with appraisal requests from

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[9] James R. Hitchner, *Financial Valuation: Applications and Methods* (Wiley Finance, 3d ed.), at 1028; *see also, e.g.*, P. Easton, R. Halsey, M. McAnally, A. Hartgraves & W. Morse, *Instructor's Copy, Financial Managerial Accounting: MBAs* (Cambridge Business Publishers, 3d ed.), Module 12 (Analyzing and Valuing Equity Securities), at 12-15 - 12-16 (Oppenheimer Valuation of Proctor & Gamble).

opportunistic dissenters seeking their unjustified windfall under the appraisal statute.

F. It Is Proper To Allocate Value to the Liquidation Preference

Allocating the actual, contractually mandated and market-validated amount of the preference in determining the value of the Company is not tantamount to recognizing a "control premium." In *Cavalier Oil* the Supreme Court rejected a minority discount on the grounds that applying such a discount at a shareholder level "injects into the appraisal process speculation on the various factors which may dictate the marketability of minority shareholdings" and "imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may reap a windfall from the appraisal process." *Cavalier Oil,* 564 A.2d at 1145. Those concerns are not present here. A liquidation preference is an economic right, not a control right. *AICPA Practice Aid* at 54 ¶ 127. The value of the liquidation preference here is not speculative: it is established by contract and subject to definite calculation. Valuing the preferred shares by their contractual rights imposes no penalty on common stockholders and no preferred shares are given any greater weight than any others.

Accounting for the liquidation preference does not afford a "windfall" for the preferred holders (to use the *Cavalier Oil* Court's term), but rather merely recognizes their contractual rights. By contrast, not accounting for the liquidation preference does provide a "windfall" to the common stockholders. Through the vehicle of the appraisal proceeding, the Common Stock would be released from its

first and primary condition: that the preferred will always be paid $24,990,000 before any common stockholders are paid. Through the artifice of an appraisal proceeding, the common shares will triple in value, and the Company will be the worse for it, as it will have paid the liquidation preference twice: first in the foregone price paid in the Merger, and again here to appellees. This, Orchard respectfully submits, is not an outcome contemplated by 8 *Del. C.* § 262(h).

Nor is this a case that presents exploitation issues. Unlike *Metromedia*, the "trigger" event here does not set the price: the price is always fixed. The preferred stockholders were not handed any greater value here by establishing the date of the merger. Indeed, the trigger event was irrelevant; what was relevant was that the fixed, determinable obligation was a liability of the company and it has to be deducted in determining the value of the common stock.

But as in *Shiftan* (and unlike *Metromedia)*, the common stock valuation "must take into account the economic reality that the Series A would have been entitled to" its preference on any sale of a controlling interest in the company or in the merger. *Cf. Shiftan*, 2012 WL 120196, at *9 & n.37. This is not a "speculative possibility, but a legally required mandate of the Certificate." *Id.* at *3.

Nor should there be a concern that the preferred stockholders effectively controlled the timing of the merger, and thus the timing of their realization of the liquidation preference's value. A824. That is a right that the preferred stockholders bargained for in the Certificate of Designations, and paid in full for. A20-28; A534-536; A782-783 at 224:5-225:23. Moreover, as a practical matter, of course,

it is virtually always the case that a majority stockholder controls the timing of "a transaction involving shareholder approval since, minimally, such a shareholder may veto the transaction." *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 599 (1986). Concerns about the timing of a transaction can appropriately be raised in a challenge to the merger, rather than in a post-merger appraisal proceeding. Indeed, some Orchard common stockholders challenged the merger in the Court of Chancery but did not prevail. A310-342.

G. The Court of Chancery Bestowed a Windfall on the Common Stockholders

The opinion of the court below effectively states that the court will consider nothing except discounted cash flow and certain traditional forms of liabilities when appraising the value of common stock. Appellant recognizes that the court is striving to create a bright-line test that can be applied in all Section 262 appraisals. While Appellant can appreciate this quest for simplicity and certainty, Appellant respectfully suggests that the formulation of the Court of Chancery here departs from the mandate of Section 262 and the actual practice of appraisal as employed by accountants valuing small cap, venture-funded companies in the commercial world. Appraising the value of stock is, regrettably, a messy business. It requires, as this Court has held, a consideration of *all* of the actual market and economic realities of a company. In the interest of streamlining, appraisal cannot become an academic exercise capable of producing, as here, an artificial result.

The Court of Chancery has bestowed a windfall on the common stockholders of Orchard they never could have realized in any other time or place. Through the artifice of a Section 262 proceeding the common stockholders have transferred to themselves, at no cost, the benefit of the preferred stockholders' investment in Orchard. The Court of Chancery's decision transfers twenty five million dollars of value from the preferred to the common, and a $25 million contractual right of the preferreds, embodied in Orchard's Certificate of Designations, has disappeared. This is precisely the arrogation of value to a class of stockholders, resulting from the merger itself, that Section 262 expressly forbids. *Cavalier Oil* reflects the Court's concern with possibility of a windfall. The decision below is just such a windfall, but for the common stockholders, not the preferred.

CONCLUSION

For the foregoing reasons, Appellant The Orchard Enterprises, Inc. respectfully requests that the Court reverse the judgment of the Court of Chancery in this matter, and remand this action to permit the Court of Chancery to appraise appellees' shares of common stock accounting for the liquidation preference.

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October 8, 2012

CERTIFICATE OF SERVICE

I, Philip Trainer, Jr., do hereby certify that a copy of the foregoing **OPENING BRIEF OF APPELLANT THE ORCHARD ENTERPRISES, INC.** was served this 8th day of October, 2012 upon the following counsel via LexisNexis File & Serve:

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