Thought Leadership

Rescissory Damages in the Delaware Court: A Viable Remedy for Stockholders or Just an Illusion?

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Seeking a full and fair recovery for stockholders who have been harmed by a board of directors that has breached its duties is the paramount goal in Delaware stockholder actions. Rescissory damages have often been alluded to as a possible remedy to resolve these breaches, but they are rarely granted. Understanding the pitfalls of achieving rescissory damages can lead to larger recoveries for stockholders.

Introduction

While pled in nearly every stockholder class action, rescissory damages remain an elusive remedy in the Delaware courts. "Delaware courts have been 'extremely reluctant' to award rescissory damages"—and particularly in the transactional context.[1]

Nonetheless when the only alternative remedy would be to unwind a consummated transaction, the Delaware courts recognize that rescissory damages are a more practical alternative. And out-of-pocket, quasi-appraisal damages are not always adequate to properly compensate stockholders, particularly where fraud or self-dealing is afoot.

However, despite significant dicta espousing the benefits of these damages, they are rarely realized by stockholders.

The History of Rescissory Damages

Rescissory damages are routed in the federal securities laws. In federal securities fraud actions, rescissory damages are available in addition to out-of-pocket losses when the price of the stock appreciated after the sale and the buyer profited.

This concept has carried over to stockholder challenges of merger transactions in the Delaware courts.

Most actions that achieve a monetary benefit for stockholders aggrieved by a disloyal board are in the form of compensatory or actual damages. Compensatory damages are designed to compensate a plaintiff (or class of stockholders) for an actual "out-of-pocket" loss caused by the defendants.

When the Delaware courts find that a merger is consummated at an unfair price, stockholders are entitled to the fair value of their stocks (minus any amount already received in the merger). To come up with these actual damages, the court looks to the same types of methodologies used in appraisal actions. The court also may rely significantly on the expert reports of valuation analysts.

Rescissory damages are also a possible remedy for a breach of the duty of loyalty—including cases where directors of a corporation are engaged in self-dealing, putting their personal interests above those of the stockholders. These damages are an exception to the typical model of actual out-of-pocket losses.

Such damages are considered to be extraordinary. This is because, unlike actual damages, these damages are measured after a merger is completed.

Because of the extraordinary nature of these damages, they are only considered in connection with a loyalty breach and not a breach of the duty of care.

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Further, rescissory damages are not available for disclosure violations in a short form merger "because under Section 253 a short form merger becomes effective before any disclosures to the minority stockholders are made."[2]

When Are Rescissory Damages Available to Stockholders?

When the rescission of a consummated transaction would be the best result for stockholders, but it is not feasible because of the passage of time or the merging of corporate assets, then rescissory damages provide the best possible solution.

"At the most general level, this remedy is premised upon the idea that (1) the transaction whereby the party gave up an asset was wrongful in some way and (2) the nature of the wrong perpetrated is such that plaintiff is entitled to more than his 'out-of-pocket' harm, as measured by the market value of the asset at or around the time of the wrong."[3]

Putting a stockholder in the position they would have been in if a fiduciary had not breached their duty of loyalty is often an improbable task. For example, once a merger is consummated, it is all but impossible for the court to order the companies to be split back in two. In circumstances such as these, rescissory damages can provide an equitable substitute.

Rescissory damages seek:

> (i) to restore the plaintiff-beneficiary to the position it could have been in had the plaintiff or a faithful fiduciary exercised control over the property in the interim and (ii) to force the defendant to disgorge profits that the defendant may have achieved through the wrongful retention of the plaintiff's property.[4]

But the Delaware courts have repeatedly rejected claims of rescissory damages based on justifications such as speculation, lack of causation, the complexity of crafting a rescissory remedy, and delay.

In *Universal Enterprises*, for example, the court rejected a rescissory damages calculation on causation grounds for failing to address the "manifold independent causes" of damages.[5] The court found that plaintiffs failed to prove that the rescissory damages sought were causally related to the fraud alleged.

In so holding, the court noted that the expert report failed to recognize other variables that may have impacted the damages aside from the alleged fraud—such as changing economic markets. *Universal Enterprises* is a clear example of the need to obtain a strong expert report in order to make a case to recover these exceptional damages.

Similarly, in *Sunbelt*,[6] the court refused to grant rescissory damages based on "significant issues related to complexity and implementation." The court found that engaging in a valuation analysis, selecting the appropriate valuation metrics and the appropriate time period under which to view these measures would "pose an issue of arbitrariness." Thus the practical difficulties in reaching a rescissory damage figure precluded one from being awarded.

And in *Weinberger*,[7] the court ultimately determined rescissory damages were inappropriate "because of the speculative nature of the offered proof."

Still these damages are often sought and have provided a meaningful benefit when plaintiffs are able to present a definitive basis for them and an explicit plan on the amounts that should be awarded.

In *Lynch II*, the seminal case regarding rescissory damages, the Delaware Supreme Court explained that it could provide a fair result for stockholders without issuing a recession order.[8]

In *Lynch II*, a proposed class action on behalf of TransOcean Oil, Inc. ("TransOcean"), stockholders challenged a tender offer by the company's controlling stockholder, Vickers Energy Group ("Vickers"), alleging that the directors had breached their fiduciary duties to stockholders. Vickers, which held 53.5 percent of the TransOcean common stock, made a tender offer to purchase the company for $12 cash per share.

Stockholders alleged that defendants did not make full and frank disclosures in connection with the tender offer and that Vickers had coerced stockholders to tender their shares.

The court entered judgment for the plaintiffs, setting forth a bright line rule that a duty of candor

fell within a board's fiduciary duties. The Chancery Court, however, found that the plaintiffs had failed to establish damages.

In reversing the Chancery Court ruling, the *Lynch II* court noted that rescission is the preferable remedy. However, when that is not possible, the court held that a fair result could be "accomplished by ordering damages which are the monetary equivalent of rescission . . . [which] is a norm applied when the equitable remedy of rescission is impractical."[9]

Lynch II determined that in order to make a stockholder whole, "the proper measure of damages should be the equivalent value of the stock at the time of resale or at the time of judgment."[10]

Relying on precedent outside Delaware, the *Lynch II* court determined that the defendants would be required to "pay rescissory damages to plaintiffs measured by the equivalent value of the [company's] stock at the time of judgment."[11]

Just a year later, the Delaware Supreme Court spoke again on the topic of rescissory damages and reversed the holding in *Lynch II* "to the extent that . . . [it] purport[ed] to limit the Chancellor's discretion to a single remedial formula for monetary damages in a cash-out merger."[12]

In *Weinberger*, the former stockholders of UOP, Inc. ("UOP") alleged that the majority stockholder, The Signal Companies, Inc. ("Signal"), had breached its fiduciary duties in connection with a cash-out merger. Signal had initially become the company's controlling stockholder through a tender offer wherein it acquired 50.5 percent of the company's common stock.

Three years after it took a controlling stake in the UOP, Signal decided to seek to squeeze out the noncontrolling stockholders. Despite two of UOP's own directors issuing a feasibility study for Signal that concluded that it would be a good investment to purchase the outstanding shares of UOP for $24 per share, Signal chose not to share this information with the company's noncontrolling stockholders or the other members of the UOP board.

Signal ultimately issued a tender for $21 per share which the board recommended the noncontrolling stockholders accept. A lawsuit ensued.

In reversing a Chancery Court ruling for the defendants, the Delaware Supreme Court held that defendants had breached their duty of disclosure and stockholders were entitled to damages including possible rescissory damages.

The *Weinberger* court was the first to establish that the court should take a "more liberal approach [which] must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court."[13]

Because the transaction was "too involved to undue" the *Weinberger* court remanded to allow the Chancery Court to consider rescissory damages in addition to considering quasi-appraisal damages.

While the Chancery Court ultimately chose not to grant rescissory damages on remand, the *Weinberger* court opened the door for the Chancery Court to take a more equitable view of the damages available to stockholders once a merger is consummated and rescission becomes impracticable.

With this equitable approach established, the Chancery Court again looked at the availability of rescissory damages in connection with a cash-out merger.

In *Technicolor*,[14] Cinerama, Inc. ("Cinerama"), the holder of 4.4 percent of Technicolor's common stock, filed an action challenging a tender offer and second step merger made by a subsidiary of MacAndrews and Forbes Group, Inc. ("MacAndrews") for $23 per share in cash.

Cinerama alleged that the Technicolor board breached its duty of loyalty to its stockholders in connection with its negotiations with MacAndrews and Ronald Pearlman (the MacAndrews controlling stockholder).

The *Technicolor* court opined that there were two primary types of rescissory damages: "The first grows out of, and is closely connected to, restitutionary relief. The second theory (and the more prominent one) employs a liberal application of the compensatory theory of damages against trustees who commit egregious breaches of the express terms of a trust or who self-deal."[15]

Under the first theory, which is the theory that was espoused in *Lynch II*, the court is seeking to prevent unjust enrichment by a self-interested fiduciary. The second theory is grounded in trust law. When a fiduciary is not interested in the transaction, but rather, has breached its duty to stockholders by not being adequately informed, these trust law damage concepts come into play.[16]

The *Technicolor* court found that even under the "trust theory" of rescissory damages, that plaintiffs must present evidence that the directors were "actually motivated by interests other than those of the shareholders." The court recognized that this

position would "arguably be a departure from the broad view of a trustee's duty of loyalty . . . it is [] consistent with the core idea of these, and other trust cases."[17]

Laches will also impede awarding rescissory damages. The principal of equity will estop an award of rescissory damages when plaintiffs excessively delay in seeking rescissory damages.[18]

The *Gaffin* court explained that a delay in seeking rescissory damages constitutes waiver by plaintiffs and "there is no requirement that the defendant show prejudice from the delay."[19]

The court reasoned that if a plaintiff was permitted to "opportunistically wait[] to see whether the defendants achieve an increase in the value of the company above its likely appraisal value, before deciding to assert a claim for rescission, or its monetary equivalent, rescissory damages."[20]

The Delaware courts have continued to follow this model. Most recently, in *Southern Peru*,[21] Chancellor Strine held that "[r]escissory damages are the economic equivalent of rescission and therefore if rescission itself is unwarranted because of the plaintiff's delay, so are rescissory damages."

This conclusion was affirmed by the Delaware Supreme Court, wherein the court noted "that the Court of Chancery properly exercised its broad historic discretionary powers in fashioning a remedy and making its award of damages."[22]

Nevertheless, the passage of time alone is not an impediment in granting rescissory damages. The Delaware courts have accepted rescissory damages as potentially appropriate in cases where a transaction has closed years earlier.[23]

The Delaware Supreme Court in *Technicolor* found that rescissory damages were an available remedy for a transaction that had closed 10 years previously. Similarly, the *Lynch II* court held in 1981 that rescissory damages should be awarded for a transaction that closed in 1974, seven years earlier.

"The passage of time of course plays a role in the availability of rescissory damages, but less so for rescissory damages than with true rescission. This is because the passage of time may be what renders rescission impractical and requires the deployment of rescissory damages as the functional equivalent."[24]

Recently, the Court of Chancery looked at the availability of rescissory damages in connection with a controlling shareholder buyout transaction in *Orchard Enterprises*. The Orchard Enterprises, Inc. ("Orchard") was taken private by its controlling stockholder, Dimensional Associates LLC ("Dimensional") in a cash-out merger.

Dimensional controlled Orchard, owning 42.5 percent of the company's common stock and 99 percent of the company's preferred stock.

Under the terms of the preferred stock agreement, Dimensional was to be provided with a $25 million liquidation preference under certain circumstances.

Specifically, the Certificate of Designations, which set forth the terms of the liquidation preference, required the payment of $25 million to Dimensional if the company was dissolved, if there was a sale of all or substantially all of Orchard's assets leading to a liquidation of the company, or if control of the company was sold to an "unrelated third party."

The going-private transaction did not trigger the liquidation preference because there was no change in control. Nevertheless, Dimensional was credited with the $25 million liquidation preference in the merger and defendants made repeated misrepresentations that Dimensional was entitled this credit under the terms of the Certificate of Designations. Further, in confirming the fairness of the buyout price to stockholders, the company's financial adviser considered the $25 million preference as being triggered based on the instruction of the board of directors.

The cash-out merger permitted Dimensional both to be credited with the full value of the $25 million liquidation preference *and* to keep all of its preferred stock. The unfairness of the cash-out merger in crediting Dimensional with the $25 million preference was confirmed by Dimensional turning around just 19 months later and merging Orchard with a Sony Music entity ("Sony")—and getting paid the $25 million liquidation preference again.

Plaintiffs alleged that by considering the $25 million liquidation preference as being triggered in connection with opining on the fairness of the price paid to stockholders, making material misrepresentations to stockholders, and allowing Dimensional to both be credited with the liquidation preference and keep the preferred shares, the board and Dimensional had breached their duty of loyalty to stockholders.

The *Orchard* action sought both traditional and rescissory damages. In a lengthy decision on the parties competing motions for summary judgment, the court granted the plaintiffs' motion in part finding that (1) the entire fairness standard of review was applicable and that it was defendants' burden to show the transaction was entirely fair as to price and process and (2) the defendants had made a material misrepresentation as a matter of law in the meeting notice provided to stockholders regarding the application of the liquidation preference.

Finally, the court found not only that rescissory damages were an available remedy, but also that those damages could be coupled with additional damages. In reaching its conclusion, the Chancery Court explained the history of rescissory damages in the Delaware courts.

The *Orchard* Court held that:

> [a]n award of rescissory damages is one form of relief that could be imposed if the merger is found not to be entirely fair and if one or more of the defendants are found to have violated their fiduciary duty of loyalty.
>
> Any award of rescissory damages only would be imposed on those fiduciaries who committed a loyalty breach. If appropriate, rescissory damages could be crafted using the Orchard/Sony Merger as the point of resale.[25]

Despite the finding that rescissory damages were potentially available at summary judgment, the plaintiffs, knowing that the Delaware courts have so rarely granted rescissory damages, chose to settle the action. The nature of the rescissory damages that were being sought was based on the value of the subsequent Sony/Orchard merger.

Finding support for ultimately awarding rescissory damages is rare enough in Delaware, but rarer still is finding support for the award of rescissory damages based on the value of a subsequent transaction or increased value of a company.

Aside from *Lynch II*—decided over 30 years ago—there does not seem to be a single opinion granting such damages under these circumstances. The settlement provided stockholders 195 percent more than initially received in the underlying transaction and accounted for elements of what the plaintiffs intended to seek in rescissory damages.

Conclusion

While the Delaware courts have repeatedly made clear that rescissory damages are available, in application they are rarely seen.

Avoiding delay and presenting a clear plan on how these damages can be calculated are, in this author's view, critical components to achieving this remarkable result for stockholders in connection with an adjudicated breach of the duty of loyalty.

Notes:

1. Universal Enterp. Grp., L.P. v. Duncan Petrol. Corp., C.A. No. 4948, 2013 WL 3353743, at *16 (Del. Ch. July 1, 2013).
2. Berger v. Pubco Corp., 976 A.2d 132, 136 (Del. 2009).
3. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1144 (Del. Ch. 1994) *aff'd*, 663 A.2d 1156 (Del. 1995).
4. In re Orchard Enterp., Inc. S'holder Litig., 88 A.3d 1, 39 (Del. Ch. 2014).
5. Universal Enterp. Grp., 2013 WL 3353743, at *16.
6. In re Sunbelt Bvg. Corp. S'holder Litig., C.A. No. 16089–CC, 2010 WL 26539, at *14 (Del. Ch. Jan. 5, 2010)
7. Weinberger v. UOP, Inc., C.A. No. 5642, 1985 WL 11546, at *7 (Del. Ch., Jan. 30, 1985)
8. Lynch v. Vickers Energy Corp., 429 A.2d 497 (Del. 1981) ("Lynch II") *overruled on other grounds by* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
9. *Id.* at 501.
10. *Id.* quoting 12A Fletcher Cyclopedia Corporations (Perm. Ed.) § 5598.
11. *Id.* at 502-503; *overruled by* Weinberger, 457 A.2d 701.
12. Weinberger, 457 A.2d at 714.
13. *Id.* at 713.
14. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1144-45 (Del. Ch. 1994) *aff'd*, 663 A.2d 1156 (Del. 1995)
15. *Id.*
16. *Id.* at 1146.
17. *Id.* at 1149.
18. Gaffin v. Teledyne, Inc., No. CIV. A. 5786, 1990 WL 195914, at *18 (Del. Ch. Dec. 4, 1990) *aff'd in part, rev'd in part*, 611 A.2d 467 (Del. 1992).
19. *Id.*
20. Ryan v. Tad's Enterprises, Inc., 709 A.2d 682, 699 (Del. Ch. 1996) *aff'd*, 693 A.2d 1082 (Del. 1997).
21. In re S. Peru Copper Corp. S'holder Derivative Litig., 52 A.3d 761, 815 (Del. Ch. 2011)
22. Americas Mining Corp. v. Theriault, 51 A.3d 1213, 1252 (Del. 2012)
23. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 372 (Del. 1993) *decision modified on reargument*, 636 A.2d 956 (Del. 1994).
24. In re Orchard Enterprises, Inc. Stockholder Litig., 88 A.3d 1, 41 (Del. Ch. 2014).
25. *Id.* at 41-42.

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