T O   O U R   F R I E N D S   A N D   C L I E N T S

M e m o r a n d u m

FRIED FRANK

www.friedfrank.com

November 11, 2008

Delaware Chancery Court Converts Voting Preferred Stock Issued to Controlling Stockholder Into Non-Voting Common Stock

Finding that the terms of $300 million of convertible preferred stock issued by Loral Space and Communications Inc. to its controlling stockholder were unfair, the Delaware Chancery Court fashioned an extraordinary remedy by converting the preferred stock into non-voting common stock based upon a court-determined “fair price” for Loral common stock. Although Loral had created a special committee of directors to negotiate the transaction, the Court scathingly criticized the committee as a special committee in name only. In Re Loral Space and Communications Inc. Consolidated Litigation (Sept. 19, 2008) demonstrates that controlling stockholders have a strong interest in ensuring that a well-advised committee of truly independent directors represent the interests of public stockholders in any transaction involving the controlling stockholder and the public company it controls.

Applying the entire fairness standard of review because a majority of the Loral board of directors was affiliated with the controlling stockholder, Vice Chancellor Strine found that the Loral preferred stock issuance was neither the result of fair dealing nor priced fairly. With respect to fair dealing, the key issue was whether the Loral Special Committee functioned as an effective proxy for arms-length bargaining. Holding that the Loral Committee did not, Strine was critical of almost every aspect of the Special Committee process.

Committee Composition – Strine held that the two person committee could not be expected to engage in the aggressive negotiations expected of an arms-length adversary because the chair of the committee was not independent and the other member was too passive. The chair was a close friend of the controlling stockholder’s founder, had been publicized as a member of the investment advisory board of the stockholder, and was seeking financing from the stockholder for his personal business ventures during the special committee process. The second committee member did not suffer from the conflicts the chair did. However, Strine emphasized that a conflict-free committee member also must function independently “in fact”. Stating that this member “brought the scientific concept of inertia to the Special Committee by generally remaining at rest until set in motion by the Committee’s advisors”, Strine concluded that this director did not demonstrate the knowledge or inclination to prod the committee and its advisors to an “effective and aggressive strategy to ensure Loral got a fair deal.”

Advisors – Noting that the “effectiveness of a Special Committee often lies in the quality of the advice its members receive from their legal and financial advisors,” Strine rebuked the Committee for its selection of a relatively obscure investment banker with no expertise in convertible securities and suggested that a more prominent firm would have been more likely to effectively deal with an aggressive controlling stockholder. Similarly, Strine criticized the lawyers representing the Loral committee because they did not take a “large strategic view of their role” instead of simply facilitating the transaction. In other words, neither advisor to the committee suggested that the committee consider alternatives to the convertible preferred stock financing proposed by the dominant stockholder.

Committee Mandate – Strine questioned the Special Committee’s limited view of its role. Advised by the controlling stockholder that Loral needed $300 million in equity financing quickly, the Committee defined its mandate as negotiating a convertible preferred stock financing from this stockholder. The Committee did not seriously consider the advice of Loral’s regular outside financial advisor that all $300 million was not required immediately and that public offerings and bank financings might be alternative sources of needed capital. Additionally, the Committee did not explore a potential investor’s expression of interest in investing $100 million in Loral. Strine questioned why the Loral Committee did not consider a broard mandate for itself, including the possibility of a sale of the entire company and doing a “market check” of financing alternatives.

Effective Negotiations – Both the chair of the Loral Committee and its financial advisor undermined the Committee’s negotiating leverage by communicating the Committee’s negotiating strategy and the terms the Committee was willing to accept to the controlling stockholder. This behavior was inconsistent with the tough bargaining expected of the Committee and its advisors.

All of these factors contributed to the conclusion that the Special Committee process did not act as a “guarantor of fairness.”

Turning to the second aspect of entire fairness, fair price, Strine concluded that the controlling stockholder extracted terms for the preferred stock which were better than market. Rather than balancing a high dividend rate with a high conversion premium or a low dividends with a low conversion premium, the controlling stockholder received a high dividend rate and a low conversion premium. Dividends were required to be paid in kind even though market terms usually permit an issuer to pay in cash or PIK at its option. Upon a change of control, a very favorable “yield protection payment” would be triggered. Finally, the preferred stock was given broad class voting rights which effectively gave the stockholder veto rights over many significant Loral actions. This class voting feature, in Strine’s view, transformed a 35% stockholder with effective control over Loral into someone with absolute control and the ability to extract for itself any control premium arising from a sale of Loral. (Indeed, Strine harshly criticized the

Committee's inadequate manner of dealing with the *Revlon* change of control/value maximization issue created by the stock issuance and used this as a basis for fashioning a remedy in which absolute control was not transferred to the dominant stockholder.)

Confronted with a completed sale of a preferred stock to the controlling stockholder, Strine used the Chancery Court's equitable powers to fashion an unusual remedy. To redress dividend, conversion and other financial terms which were highly favorable to the dominant stockholder and voting rights which raised control issues, Strine ordered the conversion of the preferred stock into non-voting common stock based upon a "fair" price for the common stock. Significantly, the forced conversion into common was not based solely on Loral's common stock trading price because the market was thinly traded and, in Strine's view, the market did not reflect material non-public information about Loral possessed by the controlling stockholder and used by it to internally value Loral well above market.

The remedy in Loral is unusual. However, Vice Chancellor Strine did not depart from existing law in evaluating the performance of the Loral Special Committee. Nevertheless, his opinion is a useful reminder of the factors to consider in establishing a committee process to effectively protect the interests of public stockholders. A team of independent and committed directors complemented by legal and financial advisors with expertise and experience in transactions with controlling parties is an essential starting point for this process.

* * *

If you have any questions regarding this client memorandum, please contact your regular Fried Frank attorney or the attorney listed below.

Author:

New York

Peter S. Golden +1.212.859.8112 peter.golden@friedfrank.com

Fried, Frank, Harris, Shriver & Jacobson LLP

New York
One New York Plaza
New York, NY 10004
Tel: +1.212.859.8000
Fax: +1.212.859.4000

Washington, DC
1001 Pennsylvania Avenue, NW
Washington, DC 20004
Tel: +1.202.639.7000
Fax: +1.202.639.7003

Frankfurt
Taunusanlage 18
60325 Frankfurt am Main
Tel: +49.69.870.030.00
Fax: +49.69.870.030.555

Hong Kong
In association with
Huen Wong & Co.
9th Floor, Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
Tel: +852.3760.3600
Fax: +852.3760.3611

Shanghai
40th Floor, Park Place
1601 Nanjing Road West
Shanghai 200040
Tel: +86.21.6122.5500
Fax: +86.21.6122.5588

Fried, Frank, Harris, Shriver & Jacobson (London) LLP
London
99 City Road
London EC1Y 1AX
Tel: +44.20.7972.9600
Fax: +44.20.7972.9602

Fried, Frank, Harris, Shriver & Jacobson (Europe)
Paris
65-67, avenue des Champs Elysées
75008 Paris
Tel: +33.140.62.22.00
Fax: +33.140.62.22.29