CASH MERGERS: A CURRENT VIEW

BY STEVEN J. ROTHSCHILD*

MR. ROTHSCHILD: You probably know from yesterday's session that both sections 251 and 253 of the Delaware Corporation Code[1] each permit cash to be used as consideration in a merger or other corporate acquisition. That's not new. 253 has permitted the use of cash since 1957 and cash was added as a permissible form of consideration in long form 251 mergers in 1967. However, even though cash has been a permissible form of consideration for in excess of twenty years, only recently has it really come into vogue in connection with mergers.

Oftentimes, of course, cash is used by an acquirer who holds no equity in the target company. As often, though, it is used by an acquirer who does hold a substantial equity position, either acquired through an earlier tender offer or open market acquisition or privately negotiated purchase.

Cash, of course, has been used for various reasons, one of which, and only one of which, has been to convert or return a public company to private status. One of the reasons why you see cash-out mergers so often nowadays is because a generally depressed market permits the acquirer to obtain something of value at a cost less than you might have to pay if you were to actually form that business from the outset. At the same time, one of the arguments raised with respect to cash-out is that it permits the stockholders to recognize a premium over what they could obtain for their stock if they were to sell it in the open market.

As I mentioned a moment ago, cash mergers have been used really for two purposes: one is to convert the public company to private status; the other is to return it. If it was originally a private company, then taken public, cash purchase now can be used to take that company and return it to private status.

The use of cash has been for a variety of reasons as I mentioned, and some of those have been legitimate and some illegitimate. In any event, what we do know is that the use of cash in merger transactions for freeze-out purposes has come under much vocal attack.

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* Admitted to District of Columbia Bar, 1968; Delaware Bar, 1969. University of Vermont, A.B. 1965; Georgetown University, J.D. 1968. Law Clerk to Hon. William Duffy, Chancellor, Delaware Court of Chancery, 1968-1969. Member: The Association of the Bar of the City of New York; District of Columbia Bar; Delaware State (Corporation Law Committee Member, 1974-present) and American Bar Associations.

1. DEL. CODE ANN. tit. 8, §§ 251, 253 (1975).

At one point in 1976 it looked like there would be relief in those situations for breach of fiduciary duties arising from private transactions available under the federal securities laws. You had the *Sante Fe* case [2] and you had the *Marshel* [3] case decided in 1976 by the Second Circuit. The apparent relief under the federal securities laws was short-lived. As you probably know, the Supreme Court took up the *Santa Fe* case and promptly reversed the Second Circuit and said that redress for breaches of fiduciary duties, unaccompanied by misstatements or nondisclosures, is a function of state courts and state laws, and it declined to federalize that substantial portion of state law dealing with securities transactions.

Shortly after the United States Supreme Court decided *Santa Fe* and reversed the Second Circuit, *Singer v. Magnavox* [4] was decided by the Delaware Supreme Court. In that case the Delaware Supreme Court said that a section 251 [5] long form merger, consummated by a majority stockholder for the sole purpose of freezing out minority stockholders, is an abuse of the corporate process and constitutes a violation of the majority stockholder's fiduciary duties.

The important thing there is that it constitutes a violation of the majority stockholder's fiduciary duties. The reason why that is so critical is because what *Singer* really represented is an application of the general fiduciary principles of Delaware law, which have long been recognized, to the merger transaction.

As you heard yesterday, and I am sure you heard it on repeated occasions, directors and majority stockholders of Delaware corporations, like corporations formed in other states, stand in a fiduciary relationship to minority stockholders and it has been repeatedly held that they must deal fairly and justly for the entire corporation.

Prior to the SUPREME COURT'S decision in *Singer,* the Delaware court had held that a majority stockholder could not manipulate corporate machinery so as to injure the minority stockholders. In each of those cases, none of which involved merger transactions, the court had held that the management's actions were done in literal and strict compliance with the applicable statute, charter provisions or by-laws, as the case may have been.

Technical compliance alone was not enough. The court said it best in the *Schnell v. Chris-Craft* case [6] where it said that inequitable action does not become permissible simply because it is legally possible.

2. Green v. Santa Fe Indus., Inc., 430 U.S. 462 (1977).
3. Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir. 1976), *vacated,* 429 U.S. 881 (1976).
4. 380 A.2d 969 (Del. 1977).
5. DEL. CODE ANN. tit. 8, §251 (1975).
6. Schnell v. Chris-Craft Indus., Inc., 285 A.2d 436 (Del. 1971).

As I mentioned a moment ago, these fiduciary duties which had been often articulated prior to *Singer* had been articulated not on the merger concept, but rather in cases dealing with such things as either a sale of assets or the selective redemption of preferred stock, or the issuance of preferred stock.

Although none of those cases did involve a merger, there are certain common threads which are discernible from those cases which preceded *Singer*. In essence, what they stand for is that corporate action must be done in accordance with the provisions of applicable statutes and it must not be violative of the fiduciary standards attendant to that transaction.

Secondly, those cases stand for the proposition that corporate action is invalid when taken by a fiduciary for the sole purpose of eliminating unwanted stockholders from continued active participation in an ongoing venture.

That brings us to *Singer*, and let me just take about two minutes to give you a little bit of background for that decision. Many of you may be familiar with it and many of you may have actually read the SUPREME COURT decision.

In essence, the complaint that was filed in the court of chancery alleged that the cash-out merger which followed the earlier tender offer was fraudulent in that it did not serve any business purpose other than the forced removal of what then was a sixteen percent minority.

The second allegation was that the defendants had breached the fiduciary duties that were owed by them to the minority stockholders in undertaking those actions.

Thirdly, it was alleged that there were violations by the defendants of the Delaware Securities Act.

I don't think it's necessary here to go into the allegations of the Delaware Securities Act. The court held that there was no causation. The SUPREME COURT affirmed on that issue but on the basis that the plaintiffs did not have standing.

The chancery court in its decision,[7] which adhered to the earlier cases, said that the merger itself was not fraudulent merely because, as had been conceded by the defendants for purposes of their motion to dismiss, it was designed solely to eliminate the Magnavox minority stockholders, and that in any event the plaintiff's remedy for dissatisfaction with the terms of the merger, and the merger price specifically, was appraisal under our statutory appraisal section which is 262.[8]

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7. Singer v. Magnavox Co., 380 A.2d 1349 (Del. Ch. 1976).

8. DEL. CODE ANN. tit. 8, § 262 (1975).

The Delaware Supreme Court heard the case and promptly decided it, and before it reached the critical issues it had a prologue in its opinion. In essence, the prologue said that an equity court must scrutinize a corporate act whose purpose allegedly violates the fiduciary duty owed to minority stockholders and that those who control corporate machinery owe a fiduciary duty to the minority in the exercise of that control.

The SUPREME COURT then turned to the various cases which had preceded *Singer* and had involved mergers, but quickly disposed of those on the grounds that they were inapposite and that none involved a cash merger whose alleged sole purpose was to eliminate the minority. Keep in mind, as I said a moment ago, that the defendants had conceded for purposes of their motion to dismiss that there was no other purpose.

The court then went on to rule that a section 251 merger made for the sole purpose of freezing out minority stockholders is an abuse of the corporate process and constitutes a violation by the majority stockholder of the fiduciary duties owed by it to the minority.

Secondly, the court held that a cash merger which is effected by a majority stockholder remains subject to judicial scrutiny, even if it is found that it has been effected for purposes other than ridding the majority stockholder of minority people.

The subject of the scrutiny in that instance, the court said, is that when the merger is found to have been effected for purposes other than cashing out the minority, the court nonetheless must determine whether the transaction is "entirely fair." Allen Terrell will be talking later on "entirely fair," and I will touch on it just briefly in a couple of minutes.

Thirdly, of significance, the court said that the defendants cannot meet their fiduciary obligations to the plaintiffs simply by relegating them to statutory appraisal proceedings. That dispensed with the argument that appraisal provided an exclusive remedy in that situation.

At this point I think most people concede that *Singer* represents a landmark decision by the Delaware courts in the merger area in that it says that the principles of fiduciary law, which have been recognized for so long under Delaware law, will apply to mergers as well as to other corporate transactions, and that redress will be available under State law to minority stockholders who were cashed-out in a merger even though it may be accompanied by complete disclosures.

In one sense, though, it really is nothing novel, that being the sense that what it represents is really nothing more in one respect than a renewed recognition of the concomitant rights and obligations of the majority, on one hand, and the minority on the other. Charles

Richards in turn will speak about the rights of majority stockholders later on this morning.

It went on to reiterate what it had said earlier, and I guess this is also one of the really significant points of this decision, that the corporate action which is statutorially possible must nonetheless satisfy the standards of equity and fairness to be permissible.

There have been a lot of developments in the short time since *Singer* was decided, and time, of course, doesn't permit us to go into each of those. One of the significant developments has been the response by the Securities and Exchange Commission with proposed Rule 13e-3.[9] There is substantial discussion in the course materials regarding 13e-3, and how it compares with the standards which appear to have been adopted by Delaware; I don't propose to go into a discussion of that here.

In addition to the response by the Commission, there have been numerous Delaware cases which have been decided since *Singer* came down from the SUPREME COURT. Those cases, of course, are now beginning to answer many of the questions which were left unanswered by the SUPREME COURT in *Singer* because it did not have those questions before it.

The first question left unanswered by *Singer,* and this was expressly left open, was whose purpose or whose business would be looked to in determining whether there was a valid purpose for the challenged merger. *Tanzer v. International General Industries,*[10] was decided shortly after *Singer,* I think it was handed down about three weeks or a month thereafter, and that answered that question. There the SUPREME COURT said that a merger made primarily to advance the business purpose of the majority stockholder was not a violation of the fiduciary duty owed to the minority.

Tanzer is interesting for a lot of reasons, and let me just highlight some of them, not the least of which is the fact that it was decided so soon after *Singer.* It really contains three significant findings which you should focus on: one, the court said that analyzing the rights of minority stockholders vis-à-vis the majority in terms of business purpose is not particularly productive because, as the COURT said, at best the phrase "business purpose" is ambiguous, and at worst, it states a result and not a right or duty.

The COURT then went on to reaffirm the right of the stockholder in a Delaware corporation to vote his shares in his own interest, including the expectation of personal property. Specifically the COURT

9. 42 Fed. Reg. 60,090 (1977) (to be codified in 17 C.F.R. § 240).
10. 379 A.2d 1121 (Del. 1977).

said that as a stockholder, I.G.I. need not sacrifice its own interests in dealing with a subsidiary.

That poses a problem, of course, because self-interest on the one hand and fiduciary duties on the other are really antipathetical concepts, and if you read *Tanzer,* to a large extent it renders illusory the protection that was afforded to minority stockholders by Singer. That tracks back, though, to the chronological proximity of the decisions. I think that the fact that *Tanzer* came down soon after *Singer* alone indicates that *Tanzer* cannot and should not be read as broadly as you might do if you weren't taking into account the fact that *Singer* was decided four weeks earlier.

I think the conclusion one comes to after reading the two cases, and after taking into account the various factors including the fact that in *Tanzer* there was no indication that the majority was simply trying to squeeze out the minority, but rather the facts were that the parent was having difficulty obtaining needed financing, and in eliminating the minority, continued active participation. It was acting on a recommendation from its outside advisers and not based on the recommendation from its inside people.

In any event, the conclusion that one comes to, or at least the conclusion that I come to, is that the Delaware Supreme Court intended the proper purpose test to be the mechanism for at least balancing or reconciling the two antipathetical concepts of fiduciary duties and self-dealing, and that not every purported purpose will be deemed to validate consummation of a cash-out merger.

Not long after *Tanzer* was decided there were some decisions by the lower court here in Delaware, that being Chancery. The first case, which Bob Payson will talk about later, was the *Kemp v. Angel*[11] case, and there the COURT was confronted with the question of whether or not the principles enunciated in *Singer* were applicable in the 253[12] short form context. In granting a restraining order and the prelimimary injunction that was requested, the COURT implicitly, though not expressly, held that the principles of *Singer* were applicable.

Since then there has been a chancery court decision, *Najjar v. Roland International Corp.,*[13] which has said expressly that the principles enunciated in *Singer* are applicable to a 253 merger and that case is now before Justice Quillen. It was argued by Bob Payson and myself about six weeks ago—I guess it was about six or eight weeks ago. We thought for sure that Justice Quillen would come in after

11. 381 A.2d 241 (Del. Ch. 1977).
12. DEL. CODE ANN. tit. 8, § 253 (1975).
13. 387 A.2d 709 (Del. Ch. 1978).

we gave our presentations and say, "Those dummies don't know what they are talking about. Here's the opinion and this is what the law really is." The case probably will be decided, I would say, within the next thirty or sixty days. This is a decision of real significance; you should watch for it.

Another issue which was left unanswered in *Singer,* but now into which I think some insight has been gained, is whether purported purposes for a cash-out will be subjected to a qualitative or quantitative analysis. That question was answered to some degree by *Young v. Valhi, Inc.,*[14] which was decided by Chancellor Marvel in 1978. That involved a proposed cash-out merger of a Delaware corporation and its newly created wholly-owned shell subsidiary.

Let me go into that just very briefly because the facts there are important and it gives some insight into what the court is looking for in these cash-out mergers.

The defendants attempted to satisfy *Singer.* Specifically they contended that the merger that would result in the cash-out of the minority stockholders had two proper business purposes: (1) the removal of possible, and I underscore possible, future conflicts of interest; and (2) tax savings that might be recognizable through the filing of consolidated tax returns.

On the second point, the COURT was satisfied that the thirty-four cents per share saving which might result from those tax savings could be obtained in the first year following the merger, but said that those same tax savings could be effected by other means.

It then turned to the alleged possible conflicts of interest, and after reviewing in detail the factual basis for the assertion, went so far as to say that it was contrived under the circumstances. What the court did, though, at that point, was something rather unusual. From there it went on to say that the reason why the merger should be enjoined, and it did go on to preliminarily and permanently enjoin the merger, was because the shell corporation was created solely for the purpose of circumventing a supermajority provision that otherwise would have been applicable.

The court then, relying on the cases which had been relied upon by the Delaware Supreme Court in *Singer,* went on to hold that conduct done in technical compliance with Delaware statutes of the CORPORATE CHARTER may nonetheless be impermissible, and the court found that structuring the merger, as it had been in that case, was indeed a case of manipulation of corporate machinery to accomplish an inequitable purpose.

14. 382 A.2d 1372 (Del. Ch. 1978).

I mentioned that the SEC has taken into account some of the very things which the chancery court and the Delaware Supreme Court have alluded to in their respective decisions, but I do not think it is appropriate to go into the Commission's response here other than to say that proposed rule 13e-3 is still before a committee, although I understand from people at the Commission that they expect it to come out shortly.

There are many questions which remain open as to the type of purposes for which mergers will be deemed to have been properly effected. I think it's best to leave that to Allen Terrell who will be talking about that a little bit later on during this presentation.

One thing that I think is important to discuss is whether or not *Singer* applies to situations other than cash mergers. I think that was one of the concerns that was originally voiced by a lot of people after the decision came down.

At this moment we don't have any specific decisions which state that *Singer* applies where you have a preferred security or where you have a debenture, or where you have notes. It doesn't apply in those situations. If you read the decision of the Delaware Supreme Court closely, though, the conclusion I come to is that if you are talking about something that is essentially the equivalent of cash, *Singer* will apply, providing, of course, that you are dealing with a majority stockholder.

On the other hand, if what you are dealing with is something that permits continued equity participation by the minority stockholders, then in all probability the tests of *Singer* with respect to purpose may not be triggered. So if you have a preferred security that is convertible, to me it's unlikely that the *Singer* tests of "purpose" will apply because you will have continued equity participation in the surviving company. On the other hand, if you are to receive in the merger not cash, but a note or a debt instrument, then in my opinion it is likely that the rationale of *Singer* would apply to that.

There are other questions which I think remain open, there again with respect to whether the tests of *Singer* will apply to certain types of securities or debt instruments. I don't propose to go into those at this point. It might be better to leave that until the open discussion which we will have later on.

Singer, as I have said several times here, involved the situation where you had a cash-out merger being effected by someone who held absolute control. In this case the parent company held 84.1% of the subsidiary.

The question which is left unanswered by Singer is what happens if the company effecting, or the individual effecting, the transaction does not have an absolute majority position, but rather has working control. What about the situation where you don't have 51%, but instead you have 49%? Will those same principles apply there?

That's going to be a very interesting question because if the principles of *Singer* do not apply here, then what we are likely to see are situations where there will be tender offers for 49% with the cash-out merger following soon thereafter. At that point, if *Singer* only applies where you have an absolute majority position, the parent company, or almost a parent at that point, would not have the same fiduciary obligations.

On the other hand, if the court were to say that *Singer* does apply where you have working control even though it's something short of an absolute majority position, then the court will have to get embroiled in the consideration in each case of whether a certain percentage ownership of the company at issue constitutes working control, and certainly in some cases only 10% of a company may be working control. On the other hand, there are some companies in which you can have 45% and nonetheless it might not constitute effective working control.

Without going into the types of purposes, because we will be dealing with those later on, what is critical to keep in mind is the fact that a purpose which is factually well founded is one thing; a purpose that is contrived or a purpose that, to quote one of my good friends at the bar, is woven of whole cloth, is something that will not suffice.

There are other areas in which *Singer* has been applied. Let me just briefly touch on those. The CHANCERY COURT has ruled that *Singer* does not change the settled law that stockholder ratification cures unauthorized acts of directors not involving a gift or waste of corporate assets. Likewise the court has said that the right of the minority not to be eliminated by the majority absent of proper purpose, does not translate into a concomitant right to continuing board representation brought about by changes in the minority's position.

There are other cases that are now before the courts. There are other cases that likely will be decided shortly by the courts that will give us additional guidance as to the extent to which *Singer* is applicable to other corporate transactions. I encourage you to watch for those as they are likely to contain some rather interesting pronouncements.