FUNDAMENTAL CORPORATE CHANGES: CASH OPTION MERGERS

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This morning I propose to discuss something that has become very popular: the use of cash in connection with a cash or a cash option (cash election) merger. Specifically, I would like to focus on developments in connection with cash mergers.

As you know, Delaware law permits the use of cash in connection with what are referred to as long-form mergers under section 251 [1] of the Delaware Corporation Code and also in connection with short-form mergers under section 253.[2] The Code also permits the combined use of cash and securities, which is really the basis of a cash option or cash election merger. The reason we have had so many developments in recent years with respect to cash-out mergers and cash election mergers is because they have become common. In turn, cash occasionally has been used as a means of effectuating a transaction which was simply unfair. Typically, these transactions have been found in the context of a company taken public and soon thereafter returned to private status for the benefit of insiders. This phenomenon has caused several developments, including ones on the state level [3] beginning with *Singer v. Magnavox Co.*[4] Although I do not propose to go into detail, let me just highlight some of the significant facts in *Singer* because they are germane to later developments and the reasoning subsequently adopted by the Delaware courts in connection with cash mergers.

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1. DEL. CODE ANN. tit. 8, § 251 (1974).

2. DEL. CODE ANN. tit. 8, § 253 (1974).

3. Developments on the federal level came in the context of the SEC's response to what it denominated as going-private transactions which in turn resulted in two rules being adopted by the Commission: rule 13(e)(3) (17 C.F.R. § 240.13e-3 (1980)), and rule 13(e)(4) (17 C.F.R. § 240.13e-4 (1980)).

The most significant development on the federal level outside of the administrative arena came in Green v. Sante Fe Indus., 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977), and in Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir. 1976), *vacated*, 429 U.S. 881 (1977). In both cases, the Second Circuit indicated that the federal securities laws provide redress for breaches of fiduciary duties arising from going-private transactions. On appeal, the Supreme Court reversed the Second Circuit and made it clear in its decisions that redress for breaches of fiduciary duties unaccompanied by non-disclosures or misstatements is a function not of the federal courts, but rather of the state courts and of state law.

4. 367 A.2d 1349 (Del. Ch. 1976), *aff'd in part and rev'd in part*, 380 A.2d 969 (Del. 1977).

In substance, *Singer* involved a tender offer by a subsidiary of North American Philips Corporation which resulted in the acquisition of approximately 84% of the Magnavox. After that 84% was acquired, a merger was used for purposes of cashing out the remaining 16% minority. The complaint filed in the Delaware Court of Chancery alleged that the second step of the cash-out merger was fraudulent in that it served no purpose other than the forced removal of the remaining 16% minority from continued equity participation in the venture. The complaint also alleged that the force-out was done at an inadequate price and in violation of the fiduciary duties owed by the various defendants to the individuals who constituted the minority at that point. The court of chancery granted the motion to dismiss filed by the defendants, and, significantly, it was in the context of an opinion granting the motion to dismiss that the matter went before the Delaware Supreme Court.[5]

In reversing the significant aspects of the court of chancery decision, the Deleware Supreme Court said first, that a section 251 (long-form) merger made for the sole purpose of eliminating minority stockholders from continued equity participation is an abuse of the corporate process and constitutes a violation of the fiduciary duties owed by the majority stockholders to the minority stockholders. The court went on to say—on an issue which has become blurred as a result of a recent court of chancery decision [6]—that, even if the merger was determined to have been undertaken for purposes other than cashing out the minority, a cash merger effected by a majority stockholder still is subject to judicial review for purposes of determining the entire fairness of the transaction. The supreme court further held that a majority stockholder could not satisfy its fiduciary obligations by relegating minority stockholders to appraisal.[7]

The primary concern of the supreme court obviously was the fiduciary obligation owed by the majority stockholder in the context of a long-form merger. In handing down its opinion, the court focused on two points: first, those who control corporate machinery owe a fiduciary duty to the minority, and second, an equity court should scrutinize a corporate act whose purpose allegedly violates those fiduciary duties.

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5. 367 A.2d 1349 (Del. Ch. 1976).

6. Weinberger v. UOP, 426 A.2d 1333 (Del. Ch. 1981), *aff'd*, No. 58-1981 (Del. Feb. 9, 1982). *See* text accompanying note 14 *infra*.

7. Lynch v. Vickers, 429 A.2d 497 (Del. 1981), speaks to appraisal, the adequacy of that remedy, and the circumstances under which appraisal is the procedure by which damages should be ascertained.

The first case which followed the decision by the Delaware Supreme Court in *Singer* was *Tanzer v. International General Industries.*[8] The issue in that case was whether a cash-out made primarily to advance the business purpose of the majority stockholder was a violation of the fiduciary duty owed to the minority. The court in *Tanzer* concluded that so long as there was such a purpose, even though it was a purpose of the majority stockholder, *Singer* was satisfied. A question which arose after *Tanzer* was whether that decision had cut the heart out of *Singer* because a majority stockholder invariably could advance some purpose for a transaction. Many people felt that the language used by the supreme court in *Tanzer* effectively subverted the holdings by that same court in *Singer*. However, if you look at the fact that *Tanzer* closely followed on the heels of *Singer* in light of the analysis actually used by the court in *Tanzer*, you have to come to a different conclusion: for one to say that *Tanzer* effectively cut the heart out of *Singer* would be to say that the supreme court went through a frolic about three weeks earlier when it handed down the *Singer* decision.

There are two specific aspects of the decision on remand in the court of chancery in *Tanzer* which warrant the attention of anybody who is really focusing on developments here.[9] First, entire fairness and intrinsic fairness were deemed to be synonymous. Second, the court on remand held that a merger price which includes a premium over market is a prima facie showing that the price was fair to the minority stockholders.[10]

Following *Tanzer* came *Najjar v. Roland International,*[11] which still is being litigated. The essence of the holding in *Roland* was that the same principles that apply in the *Singer* context, where you have a long-form merger, also are applicable in the context of a short-form merger. The defendant's argument in that case was that, by virtue of having two separate statutes, sections 251 and 253, one dealing with long-form mergers and the other with short-form mer-

8. 379 A.2d 1121 (Del. 1977).

9. 402 A.2d 382 (Del. Ch. 1978). There has also been some question during the past few years with respect to language differences in the decisions handed down by the Delaware Supreme Court; differences in wording such as "entire fairness" versus "intrinsic fairness" with respect to disclosure obligations, and whether TSC v. Northway, 426 U.S. 438 (1976), requires the same disclosure obligation that exists under Delaware law.

10. The court went on to state that the idea of synergistic benefits, which Professors Brudney and Chirelstein have focused on, is something that should not be given value in the context of a merger. There is now some renewed interest in this inquiry in light of the recent decision in *Lynch v. Vickers*, 402 A.2d 382 (Del. Ch. 1978).

11. 407 A.2d 1032 (Del. 1979).

gers, you do not necessarily have the same fiduciary obligation under one as you do under the other. The court resolved that question by stating that the fiduciary obligations of a 90% + stockholder are as great as those of a 50%-or-greater stockholder.

Specifically, what the court said in concluding that the fiduciary duty is not dependent upon the statutory basis for the merger is as follows: When and how the majority stockholder gained its position may be relevant in determining the bona fides of a business purpose when a freeze-out merger is challenged or it may be helpful at the remedy stage, but such facts are not the measure of the majority's duty to the minority. Our law applies to all majority stockholders no matter how recently such majority was obtained.[12]

The decision that served to give more insight and guidance into the type of tests that would be applied in ascertaining whether a transaction was fair was *Young v. Valhi,* [13] which involved a proposed cash-out merger between a 64% owned subsidiary and a newly created wholly-owned second tier subsidiary.

In a rare instance of this happening, the court entered a permanent injunction against consummation of the transaction in the form in which it had been structured. It did so because it concluded that the transaction had been structured to circumvent an otherwise applicable 80% super-majority stockholder vote requirement and therefore constituted a manipulation of corporate machinery to accomplish an inequitable result.

Implicit in the *Valhi* decision is the finding that, to be valid, a cash-out merger effected by a majority stockholder has to have purposes which are of substance, both qualitatively and quantitatively. As I understand it, the problem encountered by the defendants in that case and in the context of cash option mergers is to insure that all stockholders will be treated equally. If all stockholders are not treated equally, that, in and of itself, may constitute a violation of the law.

The most recent progeny of *Singer* is the series of *Weinberger v. UOP* cases. There have been several decisions, and for ease of reference let me refer to one decision as *Weinberger II* [14] and the decision of the court of chancery earlier this year as *Weinberger III.*[15]

In *Weinberger II,* a majority of the minority stockholders of UOP were required to approve the transaction, which prevented the majority stockholder from doing so by itself. That was, of course,

12. *Id.* at 1034 n.4.
13. 382 A.2d 1372 (Del. Ch. 1978).
14. 409 A.2d 1262 (Del. Ch. 1979).
15. 426 A.2d 1333 (Del. Ch. 1981), *aff'd,* No. 58-1981 (Del. Feb. 9, 1982).

contrary to the situation in *Singer* where the majority stockholder had and used its wherewithal to effect the transaction. To avoid that argument, or in an effort to avoid that argument, the majority stockholder in *Weinberger* said that we are not going to use our voting power to push the merger through; rather, we are going to make effectuation of the merger contingent upon the approval of a majority of the minority. Not only will we do that, but in an effort to ensure fairness, we will also condition the merger on the number of affirmative minority votes, when added to the number of shares being voted by the parent, comprising at least two-thirds of not all votes cast, but of all *outstanding shares* of UOP.[16]

Both of these requirements—approval by an affirmative vote of the majority of the minority and satisfaction of the two-thirds voting requirement—were satisfied. Therefore, the court concluded that the majority stockholder did not use its control of the corporate voting machinery and, as a result, dismissed the initial complaint, which was predicated on *Singer*.[17]

The *Weinberger III* decision reaffirmed the basic principles of a case you will be hearing a great deal about during the course of the seminar—*Sterling v. Mayflower*[18]—and went on to apply the points raised in *Sterling* to interested mergers. It placed the ultimate burden, in spite of the vote situation I alluded to a moment ago, on the majority stockholder to prove that the merger was fair to the minority.

The court held in *Weinberger III* that a decision by the majority stockholder not to use its position to effect a predetermined result does not vitiate the requirement that the majority have a proper purpose for a merger.

What we effectively have, as I see it, is a situation almost analogous to what one finds in the antitrust laws. Specifically, a cash-out merger effected by a majority stockholder which lacks a proper purpose will be deemed to be a per se violation of Delaware law. On the other hand, if such a stockholder has a proper purpose or if it does not use its majority position to effect the transaction, it gets by the per se test. Purpose, however, remains a part of the court's scrutiny, because in *Weinberger III*, the court said that, while the *Singer* standard would be inapplicable to such a merger, the *Sterling v. Mayflower* test would apply in determining the entire fairness of the transaction. In looking at the entire fairness of the transac-

16. 409 A.2d 1262, 1264 (Del. Ch. 1979).

17. The complaint alleged that the transaction had been effected through violation of fiduciary duties owed by the majority to the minority.

18. 33 Del. Ch. 27, 89 A.2d 866, *aff'd*, 33 Del. Ch. 293, 93 A.2d 107 (Del. 1952).

tion, one aspect of the court's scrutiny will be the purpose for the transaction. In other words, what you have is a two-tier test: you have scrutiny of purpose in and of itself at the one level; if you get by that test, or if for some reason it is inapplicable, the purpose analysis nonetheless forms a part of the second level scrutiny which will be performed by the court in determining the entire fairness of the transaction.

There are various issues which have been left unresolved by the cases that I have just summarily discussed. Some of these issues undoubtedly will be resolved in certain of the cases which are pending before the court of chancery, and also future cases which are brought. It's always difficult to talk about pending cases because it can adversely affect one's position in the litigation and whatever is said somehow seems to turn up subsequently in the context of somebody else's brief that is filed against you in later litigation.

Let me just highlight, without taking a position, some of the issues which I think remain to be answered in the area upon which we have been focusing. Number one, the valid purpose requirement: is it applicable to transactions in which minority stockholders receive surviving company stock or a security convertible into common stock? What about the situation where a non-convertible preferred stock is issued to the minority stockholders? Or what about the situation where you have a debenture—in the first instance a convertible debenture or convertible note and in the second instance a debenture which is not convertible?

What it comes down to is a question of what the court is going to treat as a cash equivalent. Certainly, if cash itself is used, that triggers, or is one of the factors which triggers, application of the *Singer* test. But what if you use something that is a little like cash or perhaps pretty close to cash? Where is the court going to draw the line? Is the court going to say that only when it is cold hard cash are we going to apply it, or is it going to say that, if whatever is offered to the minority has more attributes of cash than attributes of an equity security, the test will be applied?

Another question which arises is what happens if somebody has working, but not absolute, control? Is the test going to differ if one has 50.1% as opposed to a situation where somebody has 49.9%? Are the standards that will be applied different in those two situations? As all of you recognize, for all practical purposes he who has 49.9% can do the same thing as he who has 50.1%.

Two other questions of interest which have been given some insight into are: What purposes will be deemed proper, and what fac-

tors will the court take into account in ascertaining entire fairness? A whole host of purposes oftentimes is advanced in connection with cash-out mergers. Some of the purposes seen more often than others are the elimination of actual or potential conflicts of interest, the expansion of the combined enterprise's resource base, improvement in overall financial condition, diversification of markets, economies resulting from the elimination of duplicative departments, centralized purchasing, etc. Many of the criteria or purposes that are advanced can almost invariably be found to exist in *any* merger. Will these purposes by themselves suffice or will the court in its scrutiny of entire fairness say that benefits which could result from any combination of the companies will not suffice unless they are of substantive import in the transaction at issue?

The other interesting question now—and, again, this is highlighted by the most recent *Lynch v. Vickers*[19] decision—is what factors the court will take into account in ascertaining the entire fairness of a cash transaction. There are several points which appear to be items upon which the court will focus in determining fairness:

1) The extent of the consideration that has been given by the respective boards of directors to the proposed transaction.

2) The existence of fairness opinions rendered by investment bankers.[20]

3) The availability of alternatives to a cash or cash option merger.

4) The availability of appraisal rights to the minority.

5) The adequacy of disclosure.[21]

In addition to these five factors, purpose, of course, remains subject to scrutiny, and it is likely that the taxable or non-taxable nature of a transaction also will be taken into account, as will the existence of competing offers.[22]

There is also the question as to how, if in any way, the rationale of *Singer* will affect other principles of corporate law. The answer remains, of course, for future decisions. However, we have been given a little insight into that issue by a couple of cases handed down by

19. 429 A.2d 497 (Del. 1981).

20. Some people think that fairness opinions are something someone can get simply by asking for them and paying the requisite price. I do not agree with that theory or analysis, but in any event that is a view some people hold.

21. Even if you have satisfied the federal securities laws with respect to disclosure under rule 14a-9, 17 C.F.R. § 240.14a-9 (1969), you nonetheless might have some different disclosure obligations by virtue of state law and the obligation inherent in satisfying the test of entire fairness.

22. If there are other offers at higher prices or if the taxable nature of proposed transactions differ, those factors will be taken into account in my judgment.

the court of chancery since *Singer* and a couple of the other decisions to which I alluded.

Specifically, in *Michelson v. Duncan,*[23] the court held that *Singer* does not change the law that ratification cures unauthorized acts of directors not involving a gift or waste of corporate assets. Secondly, in the *Savin Business Machines v. Rapifax*[24] case, the court held that the right of the minority not to be eliminated by the majority, absent proper purpose, does not give rise to an unconditional right to continued board representation.

Many of the issues I have tried to highlight have come up in the context of cash mergers. As I said at the outset, however, these same considerations are applicable in my judgment to cash option mergers.[25] One should take into account these considerations in advising a client as to: 1) the desirability or propriety of using all cash or part cash, 2) the prospects that the transaction will be attacked, and 3) the considerations the court will go through in analyzing the transaction if it is subjected to scrutiny.

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23. 386 A.2d 1144 (Del. Ch. 1978), *aff'd in part and rev'd in part,* 407 A.2d 211 (Del. 1979).

24. 375 A.2d 469 (Del. Ch. 1977).

25. There are a whole host of questions which come up with respect to the applicability of various provisions of the federal securities law—sections 10, 13, and 14 which relate to cash option mergers as well. *See* 15 U.S.C. §§ 78j, 78m, 78n (1934).