PLANNING A CASH MERGER AFTER *SINGER*

BY ALLEN M. TERRELL, JR.*

MR. TERRELL: My subject involves a lot of open questions. What is business purpose, and what is fairness as the court used the terms in *Singer*[1] and developed them in *Tanzer*?[2]

I first suggest that we are faced with a two-step inquiry. First, you look to see whether or not business purpose exists in such a merger. The next step is whether the transaction is entirely fair to the minority stockholder. If the first step finds that there is no valid business purpose, you don't get to the second step. You don't go on to an inquiry as to fairness. That means, it seems to me, that the fairness of the transaction does not cure the absence of a valid business purpose.

So let's look at business purpose, and as Steve Rothschild pointed out,[3] one of our few questions that has been answered is in *Tanzer*.[4] *Tanzer* tells us that you can look to the business purpose of the acquiring corporation, and it also contains some helpful language to the effect that a stockholder can vote his shares according to his own "corporate concerns."[5]

I think you will see in my presentation my concern with the evidence and with the burden of proof because I think that many of these cases turn upon the evidence that is presented. In looking at the burden of proof, it seems clear that the majority stockholder has the burden of proof, and that that burden of proof is not satisfied simply by filing an affidavit of the merger at the time and boldly stating that the business purpose is A, B or C. The court will look behind those business purposes to see if a subterfuge is there and whether or not there is an illegitimate purpose.

The court made that clear, I think in *Tanzer,* and the subsequent cases in the court of chancery showed the extent of the inquiry even at injunctive hearing stages. A good way to look at this is to consider it in the injunctive stage.

In *Kemp v. Angel*[6] the plaintiff sought a preliminary injunction against the merger. In *Kemp,* as Steve Rothschild pointed out,[7] you

* Member of Delaware Bar. Partner, Richards, Layton & Finger. Harvard University, A.B. 1965; Harvard University, LL.B. 1968.

1. Singer v. Magnavox, 380 A.2d 969 (Del. 1977).
2. Tanzer v. International Gen. Indus., 379 A.2d 1121 (Del. 1977).
3. *See* address by Steven J. Rothschild, Seminar, Delaware Corporation Law—And Some Federal Considerations (Feb. 16, 1979) (reprinted in this issue, 4 DEL. J. CORP. L. 708) (1979).
4. *Id.*
5. *Id.* at 1124.
6. 381 A.2d 241 (Del. Ch. 1977).
7. *See* note 3 *supra.*

had first a tender offer, and then the merger. The majority stockholder got up to 90% also by converting some of its convertible stocks in AID, so that eventually the majority stockholder had a 90%.

At the preliminary injunctive stage the defendant, the majority stockholder, it seems to be in fairness, argued that the merger price was twice the tender offer price. Then he turned to business purpose and said that INA wanted to acquire AID so the corporations could file a consolidated tax return and also because the businesses of the two corporations overlapped.

I would like to read to you a short portion of Chancellor Marvel's opinion in *Kemp v. Angel.* Faced with this argument it is interesting to me the approach that the chancellor took.

He said:

> Because of the recent rulings of the Supreme Court of Delaware in the field of fiduciary duty and the fact that a merger once accomplished is difficult to undo, and because there is a reasonable probability the plaintiffs may prevail on final hearing in persuading this Court that the minority stockholders here involved would not be treated fairly were the merger complained of to be consummated, it being only at trial that the Court can give the required careful scrutiny to the testimony adduced subject to objection and cross examination as well as to other evidence offered in an orderly fashion and also test the credibility of witnesses before reaching a determination as to whether or not the transaction under attack is in fact entirely fair to minority stockholders, I conclude that this case must go to trial.[8]

That's a long sentence, but I think the point of it merely is that the court at the preliminary injunction stage when faced with contrary evidence, and as you may know this is submitted through affidavits, if there is a conflict as to whether there is a valid business purpose the court is likely to say, "I want to have a hearing on this, and I want to have a lot of witnesses and I want to see what facts sway the court as to the business purposes."

Well, Chancellor Marvel had his chance. He was faced with the matter in *Young v. Valhi.*[9] That was at a permanent injunction hearing stage and he held an evidentiary hearing as to whether or not the defendants could meet their burden of proof to show a valid business purpose for the merger. As Steve Rothschild has briefly indicated some of the facts there,[10] Contran, the parent corporation, created a subsidiary to merge the target company Valhi.

8. 381 A.2d at 245.
9. Young v. Valhi, Inc., 382 A.2d 1372 (Del. Ch. 1978).
10. *See* note 3 *supra.*

It did so really to avoid an 80% voting requirement that was contained in the charter. As you know, it is not unusual to find companies considering, or in fact having, super-majority provisions these days. But this device was to avoid the 80% vote requirement.

In addition, when faced with the challenge to the merger, Contran put in two business purposes: First, that the tax losses of one corporation could be used to off-set gains in the other corporation; and second, it would enable the corporation to avoid conflicts of interest in the event they operated in the same general lines of business.

The court looked at the evidence and found that the tax savings would really only result in about $150,000 a year, or thirty-four cents a share, and didn't think that was too compelling. The court went on to say that the possibility of future conflicts of interest was "somewhat contrived."

That's a troublesome case for those planning, or trying to plan, a cash-out merger because the evidentiary burden, I think rests upon the defendant. But if you look at the case again, you see what I consider an interesting distinction between that situation and many others where you have on-going, operating businesses.

I say that because it seems that Chancellor Marvel in the *Valhi* case was somewhat concerned about the fact that the two corporations involved were basically holding companies. The defendant's case in part was that the corporations were in a period of transition and that contracts would dispose of unprofitable assets and in the future it would be an on-going, viable business.

I want to again read from Chancellor Marvel who, when faced with that evidence and argument, said:

> I am not persuaded, however, that either *Contran* or *Valhi* can be considered to be prospective producing companies in the normal sense. Accordingly, the usual tests which apply to competitive manufacturing companies involved in the same field of production when a merger is contemplated cannot, in my opinion, be applied to the present parent and subsidiary, which are clearly not producers but rather corporations engaged in the acquisition and disposal of assets on a speculative basis with no clear-cut prospect for either of a foreseeable conventional productive period which might lead to the generating of earnings as a result of the furnishing of goods and/or services.[11]

I think we can take some comfort there that if you in fact have two corporations with a history of operating in a particular field of

11. 382 A.2d at 1373.

business and they do in fact compete, the argument used by the chancellor in his decision in *Young v. Valhi* would cut the other way. It would help support the argument that a valid business purpose was present where you did in fact eliminate a conflict of interest.

I wouldn't stop there, however, because you also have to look at when and how did the majority stockholder acquire his stock interest in the target company.

The other aspect that I bring to your attention in *Young v. Valhi* in the field of business purpose is alternatives. Why didn't you say that your business purpose will be a tax saving if you merge? The chancellor's decision in *Young v. Valhi* is a bit troublesome for a defendant because the chancellor says that the acquisition of an 80% interest in the common stock of Valhi by Contran, and the merger of the smaller Contran into Valhi, could be accomplished by means other than a cash freeze-out merger. He also says that there could be other corporate acquisitions by Contran to effect the tax savings.

We can conclude that the court will show concern if there is an obvious alternative to the cash-out merger in order to achieve your business purpose. I do think, though, that there is no Delaware case yet that has held that the defendant must show that the proposed freeze-out merger is the only practical means for achieving this business purpose.

To summarize this point, you needn't show that there is no alternative, but in planning such a merger you had better be aware of the possibility of the plaintiffs arguing that there are alternatives that you could have used other than the cash-out merger.

Turning to one of our valid business purposes, perhaps we can gain a little learning there. In Delaware there is really only one decision that says what is a valid business purpose, and that's in *Tanzer*[12] where the purpose to facilitate the long-term debt financing of the majority stockholder was found to be valid.

I think you can look at that another way because that purpose, I don't think, really was attacked by the plaintiffs. The plaintiffs did not put into evidence that that was not a true purpose. So I think that you want to have a very good record of why you needed a merger to facilitate your long-term debt financing in order to come under the *Tanzer* approach.

What I do encourage you to do also in trying to plan a merger such as this is to consider the cases in other jurisdictions. For at least the present time there are so few Delaware cases that a well-reasoned decision is not important.

12. Tanzer v. International Gen. Indus., 379 A.2d 1121 (Del. 1977).

In my outline I refer to a number of cases.[13] I won't go through them all, but I will bring to your attention at least a couple of decisions which are thorough analyses and well worth your reading.

The first one is *Tanzer Economic Associates v. Food Specialists,*[14] a New York state case involving a merger with Libby and Nestle. Libby was operating in the United States but it had financial problems and Nestle was pumping money into it. It had a long stock relationship with Libby. Libby wanted to be stronger in the United States market and the merger was proposed so that there could be improvements in coordination of management, planning, economies of scale, and so forth.

It seems to me that a merger along those lines would meet the *Young v. Valhi* type of reasoning of Chancellor Marvel. There you do have two operating companies, and you do have significant gains that could be achieved by this merger.

Another case, the elimination of a conflict of interest and a consolidation for financial reporting and tax purposes, was a valid business purpose in a New York decision. There it shows there was a common 45% stockholder vote corporation. It showed a long history of the stockholders' presence in the corporation.

A good decision, I think, is *Grimes v. Donaldson, Lufkin & Jenrette.*[15] It's a Northern District of Florida Court case. There the evidence showed that the companies were involved in the same business and the merger effected a day-to-day savings of around $300,000 a year. There is an example where the evidence was thrown in favor of a merger of this type.

Another type of business purpose is where case law supported that it is necessary to rescue the target company. The target company may be on the verge of collapsing. You may have a hard time rationalizing that as a business purpose for acquiring a company, but some of the courts are going to be more lenient in their own scrutiny of the merger.

Let's turn to invalid business purposes. What should you be aware of and avoid if you were planning such a merger?

A primary consideration is the argument that if we merge, we are going to eliminate the costs and the burdens of reporting requirements for the target company with the SEC. In other words, elimination of corporate costs.

13. A Terrell, *Consideration of "Business Purpose" and "Fairness" in Planning a "Cash" Merger, Seminar on Delaware Corporation and Some Federal Considerations* 2 (1979) (unpublished outline available at Delaware Law School Library).

14. Tanzer Economic Assocs., Inc. Profit Sharing Plan v. Universal Food Specialties, Inc., 87 Misc. 2d 167, 383 N.Y.S.2d 472 (Sup. Ct. 1976).

15. 392 F. Supp. 1393 (N.D. Fla. 1974), *aff'd* 521 F.2d 812 (5th Cir. 1975).

There are several decisions from other jurisdictions in which this is held to be not a valid business purpose, and former SEC Commissioner Sommer also agrees that that's not a proper business purpose, as well he might. I have cited in my outline[16] where a case goes the other way. I think again it turns on the facts. I could see a situation where the minority stockholders have no real market for their stock if it is not widely traded. Perhaps there are a large number of small stockholders, for example, from earlier corporations which have been acquired some years ago and are basically inactive as stockholders.

In a situation like that it may make some sense for the majority stockholder to propose a merger like this and to cash them out and consolidate the operation. It also might depend on what the financial conditions of the corporation were. It may cost a quarter of a million dollars a year for the corporation to meet all the SEC requirements, and for some corporations this may be a very real consideration in eliminating the costs. So again, I think you ought to look to what the facts are in a particular situation.

Lastly, there is a distinction perhaps as to whether or not it is going to make a difference if the corporation to be acquired is a public or a private, closed corporation. It is interesting to see that some of the cases indicate that it would be more difficult to sustain a cash freeze-out merger for a closed corporation.

I don't think that I can give you any firm guidance on this other than to say again that I think you have to look at the peculiar facts of the case and determine whether or not it really is in the interests of the majority stockholder, its own corporate legitimate interests, to have such a merger.

I would like to turn briefly to fairness. One thing we know about fairness is that it is not limited to price alone. *Tanzer* makes that clear. Chancellor Marvel in *Young v. Valhi*[17] used the term "entirely fair."

Is the transaction "entirely fair?" I suggest to you that you have to first start with the consideration to be received, the value, the cash value of the merger. My partner, Charles Richards, is speaking on the role of experts, industrial advisers, telling you what is a fair price for the stock.[18]

But when you focus on consideration you run up against an interesting question that Steve Rothschild refers to.[19] What is there that

16. *See* note 13 *supra*.
17. 382 A.2d 1372 (Del. Ch. 1978).
18. *See* address by Charles F. Richards, Jr., Seminar, Delaware Corporation Law—And Some Federal Considerations (Feb. 16, 1979) (reprinted in this issue, 4 DEL. J. CORP. L. 728) (1979).
19. *See* note 3 *supra*.

makes a cash-out, the use of cash, really different from debenture or a non-voting preferred? We don't know, I submit, whether or not debentures and non-voting preferred would come within the *Singer* test.

I think a good argument could be made based upon prior cases that the *Singer* court found inapposite, that debt itself is distinguishable from cash. Whereas in a given situation the corporation is constrained against giving up more of its stock, it has to look to debt or non-voting preferred as the form of consideration to the target company or minority stockholder.

Logically it is difficult to defend the distinction between debt and non-voting preferred and cash in the merger. I think you have to ask yourself if there is going to be a distinction between voting and non-voting. Steve talked about equity participation.[20] Frankly, I don't think the voting distinction will have much effect. You are talking about minority stockholders and presumably they would not be able to effect a corporate change, so the distinction in itself is not particularly meaningful.

It does seem important whether or not the consideration being offered to the minority stockholders gives them some way to participate in the future of the company. In other words, if it's a marketable security, will it be tied to some extent to the fortunes of the company?

If the distinction, however, is real, what do you do about a closed or a private corporation in a freeze-out merger where you have no minority? I would submit that maybe you then turn back to the voting role, whether or not they give consideration in some sort of voting security.

Finally you ought to consider the role of stock in the parent, or the holding company. For example, if the consideration consists of stock that does not come from one of the parties to the merger itself, but perhaps from a third party, a holding corporation, I would think that would pass muster. I think that would be a valid way to satisfy the *Singer* test insofar as consideration and fairness is concerned.

In the remaining time I would suggest that a major factor in considering what fairness means is timing, the time of two things: the timing of when the majority stockholder got into the corporation and the time of when he is going private. There are a number of cases in other jurisdictions that talk about the possibility of the majority stockholder taking the company public at a time when the market value makes it very worthwhile to do so, and then goes private when the market value of the stock is falling.

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20. *See* note 3 *supra*.

Vice Chancellor Brown, in the decision in *Singer*[21] spoke to that point. I think in any case our courts would be very concerned about letting the stockholder, in terms of timing, manipulate the transaction. I suggest that's another reason why the appraisal remedy is not the solution. The court made it quite clear in *Singer* that appraisal itself was no defense to a cash-out merger. I think one of the reasons is that appraisal is a determination of stock value at a particular point in time, the point in time when the majority stockholder decides upon the merger.[22]

In conclusion, let me suggest that the key to the business purpose inquiry, the fairness inquiry, seems to me to be evidentiary. You look to what is the evidence. Can you, if you are the defendant, sustain your burden of proof knowing that the Delaware courts in an evidentiary hearing will look behind the purported reason to see whether it's a subterfuge?

Secondly, insofar as fairness is concerned, look to the timing and the circumstances surrounding when the majority stockholder acquired his position in the company and when the merger occurred.

21. Singer v. Magnavox, 380 A.2d 964 (Del. 1977).
22. *See* note 18 *supra*.