RECENT DEVELOPMENTS IN DELAWARE CORPORATE LAW

BY HERBERT S. SCHLAGMAN *

There are two cases on which I would like to concentrate: *Weinberger v. UOP* [1] and *Lynch v. Vickers.*[2]

Whenever I have taught a course that includes the *Singer* [3] case and its progeny, invariably a student will ask: "Why are we studying this? If what you are saying is correct and someone sues for damages, they're going to get appraisal. Why hire an attorney and go through this process if all you can get is appraisal? Isn't it unethical to sue for damages without telling your client up front that you can't improve on the appraisal process?"

With that question in mind, I would like to take a look at two aspects of recent cases, one involving price and the other involving business purpose. Without belaboring the facts, in *Weinberger* [4] the Signal Company acquired 50½% of UOP in 1975 through a tender offer and a direct purchase from the corporation. Signal was a cash-rich company and sought to place its cash in other investments. In 1977 two attempts to acquire other businesses fell through. By the beginning of 1978 Signal had determined that its best investment would be to acquire the remaining 49½% of UOP.

An internal decision was reached to that effect, and the price was tentatively set at $20-$21 a share. At about that same time, an internal study by two executives of Signal indicated that any price up to $24 a share would be a good investment for Signal. After a very, very compressed work period amounting, in large part, to not more than a week, the board of directors of both UOP and Signal approved the proposed transaction at $21 a share. After the shareholders voted favorably on the merger, the plaintiff brought an action seeking rescission, and in the alternative, rescissionary damages.

I would first like to address the question of the determination of a fair price for an acquired corporation's stock. First, must the price be fair to the majority or to the minority shareholder? Second, do

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1. 426 A.2d 1333 (Del. Ch. 1981), *aff'd*, No. 58-1981 (Del. Feb. 9, 1982).

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

3. Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977).

4. Weinberger v. UOP, 426 A.2d 1333 (Del. Ch. 1981), *aff'd*, No. 58-1981 (Del. Feb. 9, 1982).

we have to live with the appraisal method, or may we use an alternate method?

In *Weinberger*, the court rejected the plaintiff's suggestion that, in order to evaluate the fairness of a merger, one must determine the reasonable worth to the majority shareholder to eradicate the minority shareholders.[5] Since the majority is on both sides of and controls the transaction, does not the majority bear the burden of showing complete and scrupulous fairness? And does not this burden require that the majority pay at least what the majority has determined the value of that acquired stock should be? For example, there was an indication that an internal Signal study showed that the shares were worth $24. Should not Signal be obligated to disclose to the minority shareholders both the existence of such a study as well as the basis upon which that study was made?

In *Lynch*,[6] the court noted at one point that "[t]he stock should not be valued at less than $15 per share because that was the amount Vickers had authorized to be paid third parties for open market purchases of Trans-Ocean stock."[7] The court also later noted that, "[g]iven the fiduciary relationship, the arm's length bargaining employed in the purchases should not have resulted in the minority shareholders receiving less than Vickers was ready to pay strangers for the same stock."[8] I suggest that this language recognizes that the majority has an obligation to pay to its minority what the majority would be willing to pay to strangers. Therefore, price fairness should be based upon the same factors the majority uses in determining its investment decision. Again, at the very minimum, the majority should disclose to the minority any internal study it made with respect to the value of the shares.

Let us now turn to the question of appraisal as opposed to other methods of evaluation. In *Weinberger*, the court flatly refused to deviate from the appraisal standard, but in *Lynch* the supreme court allowed recovery of "rescissory"[9] damages because there was a breach of a fiduciary duty. *Singer*, however, demands that the fair value of the shares be determined without respect to whether there is a breach of fiduciary duty. If the decision in *Weinberger* is correct, then consider the plaintiff who acts early on in a freeze-out situation. He can either seek damages or an injunction of the proposed transaction.

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5. *Id.* at 1360.
6. Lynch v. Vickers, 429 A.2d 497 (Del. 1981).
7. *Id.* $12 had been paid originally.
8. *Id.*
9. *Id.*

If he seeks to enjoin and is successful, he will be left in a corporation that he knows wants no part of him, and he knows that his investment in that corporation will suffer one way or another. If he seeks damages, then he is caught in section 262.[10] If such is the case, why should he bring the action for damages? Either way it is a "no-win" situation, unless we take the cynical view that the purpose of *Singer* is to delay the action in order to reach a settlement—*Young v. Valhi*.[11] I don't think that was the thrust of the *Singer* decision.

In the context of the fiduciary duty to treat the minority fairly by determining a fair price, one wonders whether the conservative method used in the appraisal proceeding is appropriate. A more equitable approach would be to use the same analyses whenever a firm makes an investment decision, whether it is a discounted cash flow analysis or a comparison of transactions method—both of which were urged in the *Weinberger* case.

I would also note that the established practice of paying a premium for minority stock in freeze-out situations indicates that the appraisal standard is not a test of fair value because premiums above appraisal prices would not be offered if their addition would make the resulting offer an unsound investment decision. The very existence of the premium suggests that the majority shareholder is using a form of analysis different from the appraisal standard to determine the merits of his investment. It is that form of analysis that, I suspect, governs in the breach of fiduciary relationship situation as found in *Lynch*.

Furthermore, total reliance on the appraisal method would seem to be contradicted by the language in *Singer* to the effect that a plaintiff cannot be relegated to an appraisal remedy if that language is applied to situations where the plaintiff seeks damages as opposed to injunctive relief. There is no logic in saying that you cannot be held to an appraisal remedy in an action in which you are seeking damages if the court is going to apply the appraisal method to determine your benefits.

Now, let us look at the *Lynch* decision. *Lynch* is troublesome, at least to me, because it appears to introduce the possibility of new approaches while simultaneously using old applications. At the trial level, the court of chancery used the appraisal test to measure damages

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10. DEL. CODE ANN. tit. 8, § 262 (1974). Payment for stock or membership of person objecting to merger or consolidation.

11. 382 A.2d 1372 (Del. Ch. 1978).

for fraud. The court determined the value of the shares to be $11.85;[12] $12 had been paid on the tender.

On appeal, the supreme court noted the breach of a fiduciary duty and ordered rescissory damages. I do not pretend to be an expert in contract or tort law, but it has been my understanding that rescission has always been the proper remedy for fraud, negligent misrepresentation, or breach of fiduciary relationships. In this respect, I do not think the court has charted new waters. However, the court did stress the fact that

> [t]he difference is important because the appraisal approach adopted in *Poole* has a built-in limitation, namely, gain to the corporation resulting from a statutory merger is not a factor which is included in determining the value of the shares, and it was not considered by the Chancellor. But that limitation does not apply when a fiduciary has breached a duty to those to whom it is owed.[13]

This language by the court suggests that we can now look to value in a corporation. It appears to expand the measure of damages; however, upon closer examination of the context in which it is used, the court really seems to be stating that the trial court incorrectly weighted the standard appraisal factors.[14] In giving what only could be called instructions, the court said that too much emphasis may have been placed on market value at the expense of asset value because the company involved was an oil-rich company.[15] I would note that such language smacks solely of the appraisal test: it's an appraisal test with emphasis on whether or not asset value is more significant in this case than market value or earnings value. Again, the language that I read to you to the effect that gains to the corporation resulting from the transaction must be considered may suggest that by the time *Weinberger* goes up on appeal the court will be ready to meet head-on the question of whether section 262 supplies the only method of determining the value of shares.

Even that statement troubles me. I do not think section 262 itself sets out a mandate for how shares will be evaluated in all freeze-out situations. The area of mergers is primarily a judicially developed area, and what was fine in 1940 may not be appropriate in 1980.

Finally, I would like to address the question of business purpose. In *Weinberger,* the court held that Signal was motivated by its own

12. Lynch v. Vickers, 402 A.2d 5 (Del. Ch. 1979).
13. 429 A.2d 497 (Del. 1981).
14. *I.e.,* asset value, market value, and earnings value per share.
15. 429 A.2d 497 (Del. 1981).

economic interests. Signal had surplus cash and had been looking for suitable investments. The court found that Signal's desire to invest this excess cash created a legitimate purpose for the UOP merger.[16] Other purposes were mentioned briefly but not discussed in depth.

The question addressed by the court was: If a cash-rich company owns the majority interest in another company and seeks to buy out the rest of the other company as an investment decision, is that a proper business purpose? The court reviewed the language in *Tanzer*[17] to the effect that a proper purpose is one that is legitimate *and* present *and* compelling, but held that *Tanzer* did not indicate that every business purpose was required to meet all three of these conditions. In so holding, the court relied upon *Sterling v. Mayflower Hotel Corp.*,[18] in which the supreme court upheld a merger where the majority stockholder had indicated from the very outset of the transaction that it intended to integrate the Mayflower holdings into one unit. I find some problems in relying on *Sterling* in such a situation because *Sterling* never addressed the question of business purpose.

I think *Tanzer* stands unaffected; the key words are still legitimate *and* present *and* compelling. Is the desire of a cash-rich company to acquire complete interest of a subsidiary a compelling need? It may quite well be legitimate because the mere fact that you want to buy out the remaining shares does not mean that you want to freeze-out people; it means you want a better investment for yourself. But is that a compelling interest? I do not see that the words "compelling" and "a better investment decision" relate to one another at all. Therefore, I think that the business purpose aspect of the *Weinberger* decision is certainly questionable, in addition to being a major retreat from the holdings in *Singer* and *Tanzer*.

16. 426 A.2d at 1350. The court also noted here that prior to the UOP merger, Signal had unsuccessfully negotiated for two other acquisitions.

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

18. 33 Del. Ch. 20, 89 A.2d 862, *aff'd*, 33 Del. Ch. 293, 93 A.2d 107 (Del. 1952).