FUNDAMENTAL CORPORATE CHANGES:
DEVELOPMENTS INVOLVING SALES OF ASSETS—
PART I

By Charles S. Crompton, Jr.*

I am going to develop a little different theme now and talk, not about using cash to acquire new businesses, but about trying to raise cash by selling off old businesses, or what a recent article in the Marketplace column in the New York Times called “redeployment of assets.” In that article, the author notes that the American Can Company recently announced it was going to sell a major part of its paper and forest products division, and its stock price immediately went up about five points to its highest level in ten years. The column also noted that Richardson-Merril stock rose about fifty percent last fall when they announced a similar sale of a major division. Some other recent large corporations were listed which had had significant market increases in their own shares by selling major portions of their assets. The commentator concluded that this pressure to redeploy assets and get the best available return for them is going to continue and even increase.

Frankly, I thought this was rather a dead subject and one that was not nearly as sexy as the acquisitions, tender offers, mergers, and other topics my friends have discussed here, but it looks like, at least until the stock market rebounds, that you might see more and more of this kind of asset sale transaction.

Therefore, it might be profitable to run through five or six areas involving problems that might arise in connection with the sale of corporate assets.

The first is one called an Oppenheimer transaction, which takes its name from the investment banking house that initiated this type of transaction. There is very significant potential in this area for both state and federal problems to arise because of the inherent conflict of interest between two groups of the shareholders in such a transaction. This transaction usually involves a public corporation which is controlled by a relatively compact group of insiders, who have a very low basis for their shares. The management group arranges to sell the corporate business to a new shell corporation, and

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then convert the old company into a private investment company by making a tender for its publicly-held securities and then amending the charter to change its purposes.

The purchasing company will normally continue the seller's business as a private company, often controlled by the same small group of management who usually continue their employment under long-term management contracts.

Frequently, the buy-out is fully leveraged, that is, it will be with financing almost entirely secured by the assets purchased, and the purchaser assumes all the liabilities of the public seller.

The insiders, through these steps, gain very substantial benefits from the transaction which may not be available equally to all the shareholders of the seller, and a potential conflict of interest is apparent. The insiders are obviously able to convert their equity interests on a tax-free basis often into an investment company, with a higher rate of return, and the distribution of the investment company income may be even further tax-sheltered if the company qualifies as a regulated investment company.

The management group, of course, also often obtains favorable long-term management contracts to continue the business operations transferred to the new company. In addition, the insiders frequently benefit from increased liquidity in their own estates if they are in the process of estate planning.

On the other hand, the public shareholders are cashed-out with the usual problems that are familiar to us. If they tender their shares, they have those cash-out problems such as the risk of not receiving a fair price. If they retain their shares in the former operating company, they are going to hold stock probably in a closed-end investment company, which usually sells at a substantial discount from its assets, if there is any market at all for the shares.

The only reported decisions that I have seen which deal with the problems caused by this Oppenheimer transaction are under federal securities laws, either SEC or federal cases, but it's apparent to me that these conflicts offer fertile ground for litigation under both state and federal laws governing the fiduciary duty of management and the disclosure requirements of rule 10b-5.1

Maybe the simplest way to describe these issues and how they have been raised is to talk a little bit about the facts of one transaction which drew the Commission's attention recently, the Spartek2

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matter. There, a public company listed on the American Stock Exchange proposed to sell its assets to a new Delaware corporation organized for the sole purpose of acquiring those assets at a price which was $4 below the book value of the assets, but well in excess of the current market price of the shares.

There were two members of the management group who controlled about forty percent of the stock of the company, and they, of course, announced they were voting in favor of the transaction.

It was contemplated and announced that the new company would continue the operations of the business and that there were seven senior members of management, including the two forty percent shareholders, who had lucrative fifteen-year employment contracts with the new company. It was also announced that, after the completion of the sale of the assets, Spartek intended to: make a cash tender offer to buy in its shares from the public, amend its charter to become a closed-end diversified investment company specializing in tax-free securities, and seek to qualify as a regulated investment company.

The control group there was to receive all the benefits that I talked about earlier and the expectation was that the public shareholders would be cashed-out.

The Commission ruled that Spartek's proxy material was deficient because it failed to disclose information concerning the conflicts inherent in this transaction and the special benefits which were available only to the insiders. While there is a list of factors that the Commission said would have to be specifically set forth in the proxy, one thing that I think makes the case somewhat distinguishable from other leveraged buy-outs is a memorandum which one of the forty percent shareholders sent to the other in what must have been one of the dumbest moves of his life. That memorandum stated that the writer realized that the consideration offered for the assets was five percent or six percent below their real value, but it was more than worth it to the insiders because of the personal tax and other advantages they would receive.

3. Id. at 81,402 & 81,407.

4. These factors included:

(1) the special interest of the management group to earn tax-free income from Spartek operating as a regulated investment company;
(2) the long-term contracts assuring that the incumbent management group at Spartek would control the daily operations of the company which purchased Spartek's assets;
(3) the transfer on a tax-free basis of management's equity investment in Spartek into a more diversified and liquid investment company; and
(4) the greater personal estate liquidity obtained by the members of the management group.

Id. at 81,405.
I do not think the Commission needed much more than that, and I hope that the *Spartek* release and the list of factors it lists as "material" factors will perhaps help in future planning of such transactions.

The most important thing, I think, about the Commission's release is the very stringent standard or test it said it was going to apply to this type of transaction. Let me just read from the release to highlight that standard. The Commission stated:

Under circumstances where, as here, the proposed transaction would result in a substantial change in the nature of the investment of public shareholders and was designed to give management certain special benefits by reasons of their tax situation and otherwise, which would give them an incentive, not shared by other shareholders, to favor the transaction, *meticulous care is required to assure that full and fair disclosure of all material facts relating to the transaction is made.*

This meticulous care standard, I suppose, could be the basis for the same kind of claim under a common law count in a state court—that when special benefits are available only to insiders, the court might look at the transaction with even more than the entire fairness test with which we are familiar under the *Singer v. Magnavox* line of cases.* I am not quite sure what a meticulous care standard might mean, but I would be concerned that such a stringent standard might be applied even in a state court action.

5. *Id.* at 81,407 (emphasis added).