WACHTELL, LIPTON, ROSEN & KATZ

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TO OUR CLIENTS

# Going Private

A public company may still go private. It is legal under both federal and state law. With careful planning it can be accomplished readily. While almost all going private transactions during the past two years have drawn the attention of the class-action bar, it is now clear that a well structured going private transaction will not be upset by the courts. (Private company freeze-outs are another matter and what is said herein does not necessarily apply to private company freeze-outs).

Judge MacMahon's June 24, 1975, opinion in the Concord Fabrics cases is the latest in the recent series of Second Circuit cases that have sustained going private transactions. In a classic going private situation Judge MacMahon held that neither Rule 10b-5 nor state corporation law precluded a going private transaction where the price was unfair and there was no bona fide corporate purpose other than going private and that the only right of the objecting shareholder was the statutory appraisal right.

Concord Fabrics is a classic example of the going private phenomenon. Prior to 1968 Concord was a private company. In the new issue markets of 1968-69 Concord sold 300,000 shares in a public offering at $15 per share and then the controlling family sold 200,000 shares in a public offering at $20 per share. In 1969 Concord listed on the American Stock Exchange. Concord stock reached a high of $25 per share in 1969 and declined to $1 in 1974. The decline in market price paralleled a decline in earnings and discontinuance of dividends. With the stock at $1 per share Concord decided to go private at $3 per share. The $3 valuation was based on the opinion of an investment banker who had had prior dealings with Concord and who was related to a director of Concord. The controlling family transferred its 68% of the Concord stock to a private corporation and then Concord entered into a cash merger agreement with the private corporation. Concord made arrangements to borrow the funds to pay the cash merger price. Under

the applicable New York Business Corporation Law 66 2/3% of the stock could authorize the cash merger and shareholders objecting to the cash merger price would have statutory appraisal rights.

Thus, Concord Fabrics presented all of the unappealing aspects of going private:

1. The corporation was going private within six years of a secondary public offering and listing on a stock exchange.

2. The going public price was substantially greater than book value, while the going private price was substantially less than book value.

3. The going private price was 85% below the secondary public offering price.

4. The corporate assets were being used to finance the cash merger.

5. The board of directors which authorized the transaction was controlled by the insiders who would own 100% of the corporation after the merger.

6. The investment banker who had opined on the going private price was of questionable independence.

7. There was no business purpose for going private other than the elimination of public ownership.

8. The public shareholders had no voice in determining the transaction -- the 68% controlling interest would authorize the merger no matter what percentage of the public shares objected.

9. The insiders did not have the 95% ownership necessary for a short-form merger in New York and the

going private transaction was structured with a "shell" intermediary corporation in order to take advantage of the New York long-form cash merger statute.

However, Concord did make full and complete disclosure in the proxy statement for the shareholders meeting called to authorize the cash merger. Indeed, like the Wells, Rich & Greene prospectus, the Concord proxy statement is a classic model of full disclosure in a going private situation. Rejecting Bryan v. Brock & Blevins Co., 343 F. Supp. 1062 (N.D. Ga. 1972), aff'd. 490 F. 2d 563 (5th Cir. 1974) and Albright v. Bergendahl, CCH Fed. Sec. L. Rep. ¶ 94,997 (D. Utah 1974) the two cases that have held going private transactions to be subject to Rule 10b-5, Judge MacMahon followed the Second Circuit principle expressed in Popkin v. Bishop, 464 F. 2d 714 (2d Cir. 1973) that Rule 10b-5 is limited to disclosure and does not reach the question of the fairness of corporate transactions, Judge MacMahon's opinion states:

> Plaintiffs' claims that there has been a Rule 10b-5 violation because of the unfair and inadequate price to be paid for the Concord shares and the absence of a bona fide corporate purpose for the merger are patently without merit. Rule 10b-5 simply does not encompass these alleged wrongs.
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> Although plaintiffs do allege a myriad of misrepresentations and nondisclosures in connection with the proposed merger, thus lumping their claims within the ambit of Rule 10b-5, we find little factual substance to these allegations. The thrust of plaintiffs' allegations of nondisclosure is that defendants did not disclose the illegality of their actions, i.e., that the merger had no valid business purpose, that the price to be paid for the Concord shares is inadequate, that the [controlling insiders] are benefitting themselves to the detriment of the public shareholders, and that what is described as a merger is no more than a fraudulent scheme.

> The proxy statement, we find, is not misleading. Nor does it fail to disclose any material information. [All it] appears to omit is plaintiffs' legal conclusion that the merger is illegal. We see no indication, at least at this juncture of the litigation, that the conclusion is well founded.

The validity of the Second Circuit position in Popkin v. Bishop and its progeny is supported strongly by the recent Supreme Court decision in Cort v. Ash, 43 U.S.L.W. 4773, 4778 (June 17, 1975) in which the Court said: "Corporations are creatures of state law and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation".

Judge MacMahon also dealt decisively with the state corporation law issue -- whether a long-form cash merger can be used by the original controlling insiders to go private. In what is believed to be the first opinion directly on this point (David J. Greene & Co. v. Schenley Industries, Inc., 281 A. 2d 30 (Del. Ch. 1971) sustained a long-form merger freeze-out which followed a third party tender offer acquisition of a controlling, but not sufficient, interest to permit a short-form merger) Judge MacMahon said:

> We find plaintiffs' contention that they are entitled to a preliminary injunction for violations of state law equally without merit. Where a merger is to be accomplished in accordance with statutory proceedings, as here, appraisal is the only remedy available to dissenting shareholders.
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> "In short, the merged corporation's shareholder has only one real right; to have the value of his holding protected, and that protection is given him by his right to an appraisal. . . . He has no right to stay in the picture, to go along into the merger, or to share in its future benefits . . . . ."

> The remedy of an appraisal and payment for one's shares affords fair and just compensation to dissenting stockholders while allowing the overwhelming majority to proceed with the merger." [Willcox v. Stern, 18 N.Y. 2d 195, 201-02 (1966) (a short-form merger)]

In another recent going private case Green v. Santa Fe Industries, Inc., Fed. Sec. L. Rep. ¶ 95,085 (S.D.N.Y. 1975) a short-form going private merger was sustained. Santa Fe owned 95% of Kirby, a Delaware corporation. Santa Fe formed a new Delaware shell and transferred the 95% to the shell. The shell then effected a Delaware short-form merger of Kirby paying the minority $150 cash per share. The next day the minority shareholders were sent a comprehensive information statement detailing the short-form merger and the related Delaware appraisal procedures, a statement of Kirby's income, appraisals of the value of Kirby's stock and assets and a history of the dealings between Santa Fe and Kirby. A Morgan Stanley appraisal of $125 per share based on audited financials for the last fiscal year, unaudited financials for the most recent stub period, Kirby's five-year profit forecast and appraisals of Kirby's assets was appended to the information statement along with the opinions of the asset appraisers. The Court held:

> (1) Rule 10b-5 does not supersede state short-form merger statutes; Rule 10b-5 does not proscribe all freeze-outs; Rule 10b-5 does not require that there be a valid business purpose -- other than elimination of the minority -- for a short-form merger.

> (2) Rule 10b-5 does not require notice of a short-form merger before it is consummated.

> (3) "This Court does not regard Rule 10b-5 as an omnibus federal corporation law having such broad reach as to modify the notice requirements of the Delaware merger statute, or prevent Delaware, in its legisla-

tive wisdom from providing a means by which a majority can exclude a minority from the corporation's future affairs, so long as due process is satisfied, as it is here, by the appraisal procedures."

(4) The investment banking opinion, appraisals and history of prior purchases of Kirby stock by Santa Fe satisfied the disclosure requirements, accordingly adequacy or fairness of the merger terms are not at issue under Rule 10b-5.

(5) The proposal of the SEC to adopt specific going private rules under § 13(e) of the Securities Exchange Act supports the proposition that if full and fair disclosure is made, transactions eliminating minority interests are beyond the purview of Rule 10b-5.

Less than two weeks prior to Judge MacMahon's Concord Fabrics decision, Justice Markowitz in the New York State Supreme Court granted a temporary injunction to the New York Attorney General in an action under the New York Martin Act to prevent Concord from going private. The Attorney General's basic theory appears to be that a freeze-out of public stockholders is per se a fraudulent scheme within the Martin Act. Judge Markowitz did not reach any of the substantive questions: "The sole issue here is whether the State has an interest in investigating and seeking to have vitiated a proposed merger or freeze-out of minority stockholders under its police power, where proper grounds exist." However, Judge Markowitz did not refrain from reflecting his attitude toward the transaction:

It would thus appear that under the broad powers afforded the Attorney General, under Article 23A of the General Business Law, the security transactions such as are involved in this proceeding are proper targets for his scrutiny despite the fact that full disclosure of the aims of the [controlling insiders] have been articulated. What is disquietingly evident here is the fact that a group of insiders who are directing the

reacquisition program, even controlling the appraisal of the stock are the very ones who made the company public originally, and will be the surviving shareholders in the proposed privately-held enterprise. Adding to the odium of the scheme is that fact that no real corporate purpose has been demonstrated and that the credit of a now public corporation will be used to finance a merger for the benefit of a private group.

The Concord Fabrics cases when considered together with the SEC proposals to regulate going private transactions, SEC Securities Act Release No. 5567 (Feb. 6, 1975) and the other recent cases such as Bryan v. Brock & Blevins, supra. Grimes v. Donaldson, Lufkin & Jenrette, Inc., CCH Fed. Sec. L. Rep. ¶ 94,722 (N.D. Fla. 1974); Kaufmann v. Lawrence, 386 F. Supp. 12 (S.D.N.Y. 1974) aff'd - F.2d - (2d Cir. 1975) and Green v. Santa Fe Industries, Inc., supra, provide a road map for going private. While based on Judge MacMahon's opinion in Concord Fabrics it is possible to argue that all that is necessary is full disclosure and compliance with the applicable state law merger and appraisal procedures, it would be foolhardy not to recognize that going private has generated intense opposition and public concern. Accordingly, going private transactions should be structured within the following guidelines.

(1) The going private price should be determined in a manner designed to achieve objective fairness. It is suggested that a committee of independent directors aided by the opinion of an independent investment banker will go a long way toward satisfying this requirement.

(2) If there are sophisticated holders of a substantial part of the public interest, direct negotiation of the going private price with one or more of such holders is desirable.

(3) The public shareholders should be accorded appraisal rights. This can be accomplished either by structuring the transaction so that statutory appraisal rights are available or by voluntarily providing appraisal rights.

(4) Except where the short-form merger procedure is applicable, the public shareholders should be accorded the right to vote on the transaction. This can be accomplished by providing that the insiders will vote their shares for the transaction only if approved by a plurality of the public shares.

(5) It is not necessary to dream up business reasons other than the desire to go private. If there are other reasons so much the better, but they are not essential.

(6) It is generally simpler and more direct to go private in one step through the long-form cash or debt merger rather than the two-step tender offer followed by a short-form merger route. The long-form merger procedure has the advantage of according statutory appraisal rights to all shareholders at the time the decision to go private is made and to eliminate the "shake-down" aspect of the going private tender offer which coerces shareholders to tender for fear of being left with no real public market and perhaps no information about the company. See Borden, *Going Private - Old Tort, New Tort or No Tort*, 49 N.Y.U.L. Rev. 987 (1974).

(7) Absent cogent business purposes, management which does not have a significant ownership interest should not attempt to use the corporate assets to go private. See *Borden*, *supra*.

It is not necessary that all of these guidelines be followed in each going private transaction. In addition to full disclosure the key element is a means of assuring that the going private price is fair. The particular facts of each going private situation and the current interpretation of the applicable state corporation law will dictate how many of these guidelines should be followed. It appears that with the possible exception of the business reason requirement even the most restrictive state would not interfere with a

going private transaction that followed all of these guidelines. On the basis of David J. Greene & Co. v. Schenley Industries, Inc. supra, Green v. Santa Fe Industries, Inc., and the Concord Fabrics cases it appears that the key states of Delaware and New York do not proscribe the well planned going private transaction.

M. Lipton