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To Our Clients

Recent Developments

1. Controlled Corporation Merger; Post-Merger Gain-Sharing not Required by Delaware Law or Rule 10b-5; Rule 10b-5 Does Apply to Corporate Mismanagement and Does Require Fairness. In Harriman v. E.I. DuPont de Nemours and Co., CCH. ¶ 95,386 (D. Del. Dec. 23, 1975) shareholders of duPont attacked derivatively a merger between duPont and Christiana Securities Co. (a closed-end registered investment company originally formed to perpetuate control of duPont in the duPont family) on the ground that the merger exchange ratio was unfair to duPont and therefore violated Delaware law and Rule 10b-5. The principal asset of Christiana is 28% of the common stock of duPont and as a practical matter the ownership of a share of Christiana is equivalent to the ownership of the proportionate interest in duPont common, except that historically Christiana common sold at a 20-25% discount from its net asset value. The merger provides an exchange of duPont common for Christiana common with a 2-1/2% discount in favor of duPont. The basis for the plaintiff's attack was the claimed inadequacy of the 2-1/2% discount compared to the benefit to the shareholders of Christiana who after the merger would own directly shares of duPont and thereby have eliminated the market discount of 20-25%.

The merger was negotiated by committees of independent directors of the two companies. The merger exchange ratio (the 2-1/2%) discount was within the range of the fairness reports of three investment bankers -- one jointly retained and the other two individually retained, one by Christiana and one by duPont. The individually retained investment bankers had no previous investment banking relationship with either Christiana or duPont.

With respect to Delaware law the Court first held that the intrinsic fairness test (careful scrutiny by the court with the proponents having the burden of showing fairness), rather than the business judgment rule (presumption that the transaction is legal unless the plaintiff shows no rational business motive) applied. The basis for this holding was not the traditional elements of control and self-dealing but rather that since the SEC had already determined that the merger satisfied the fairness requirements of the Investment Company Act of 1940, a Delaware court would not "undertake the hollow intellectual exercise" of measuring the merger by the much less rigorous business judgment rule. Then the Court held that the intrinsic fairness test does not require equal sharing of post-merger gains between the parties to a merger. The Court referred to the Brudney and Chirelstein article ("Fair Shares in Corporate Mergers and Takeovers", 88 Harv. L. Rev. 297) and expressly rejected it as reflecting Delaware law. The Court said:

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"the prevailing Delaware law on fairness requires only that the consideration paid be equivalent to the premerger value of the exchanged shares and pays no attention whatsoever to any resulting post-merger gains." However, in a footnote the Court indicated that in certain situations, such as a parent-subsidiary merger [or a going-private freeze-out], post-merger gain-sharing might be an appropriate "device to artifically provide the otherwise missing arms-length bargain."

With respect to Rule 10b-5 the Court expressly held that the Rule reaches corporate mismanagement even in the absence of any misrepresentations or failures to disclose (citing Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974)). The Court said that Rule 10b-5 requires fairness in a merger where one party controls the other and that such fairness should be determined not on the basis of the relative benefits to the parties, but on the basis of whether the controlled party received either "wholly inadequate consideration" (citing Schoenbaum v. Firstbrook, 405 F.2d 215, 219 (2d Cir. 1968)) or a "fraudulently low price" (citing Pappas v. Moss, 393 F.2d 865, 869 (3d Cir. 1968)). The Court then examined various valuation factors taken into account in negotiating the merger and found as a fact that there was no basis for the plaintiff's attack — that each factor was fairly reflected and that net asset value rather that post-merger gain-sharing was the proper standard.

The Court rejected an argument by the plaintiff, that it would be a violation of Rule 10b-5 for the controlled party to negotiate a merger without meaningful financial advice. After rejecting the factual predicate for the plaintiff's argument, the Court said "it is not at all clear that any financial advice is necessary, even in the negotiation of a transaction between parties that are so inextricably intertwined that arms-length bargaining is an absolute impossibility."

Despite the rejection of the financial advice argument, it appears that the Court was strongly persuaded by the comprehensive reports by the investment-banker advisors and the negotiation of the terms by committees of independent directors. There can be no doubt that this is the way to do a conflict transaction.

2. Tender offers; Offeror Obtaining List of Shareholders of Target. In Re Crane Co., N.Y.L.J. Jan. 7, 1976, p. 7, col. 1 it was held that the desire of a shareholder to communicate a hostile exchange offer to the other shareholders of the target was not a purpose that involves the business of the target within § 1315 of the New York Business Corporation Law and therefor the offeror was denied the list of shareholders of the target.

3. Margin Regulations; Indirect Security under Regulation U. The Ninth Circuit has reversed the district court holding in Cooper v. Union Bank and has held that provisions in a loan agreement requiring monthly

accountings of security transactions and a particular person to be the primary broker do not constitute the securities in the brokerage account as indirect security for the loan. CCH. ¶ 95,384 (9th Cir. Dec. 5, 1975)

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