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To Our Clients

Going Private - Second
Step Acquisition Freezeouts

Subsequent to the Second Circuit decisions in Marshel v. AFW Fabric Corp. (Concord Fabrics), [Current] CCH Fed. Sec. L. Rep. ¶ 95,448 (2d Cir., Feb. 13, 1976) and Green v. Santa-Fe Industries, Inc., [Current] CCH Fed. Sec. L. Rep. ¶ 95,447 (2d Cir., Feb. 18, 1976) that going-private-type transactions as to which full disclosure has been made but which had no corporate purpose other than the freezeout of the minority shareholders were fraudulent transactions within the proscription of Rule 10b-5, the New York Supreme Court has substained two second-step-acquisition transactions -- in one case a long-form preferred stock merger following a cash tender offer, Schulwolf v. Cerro Corp., N.Y.L.J. Feb. 15, 1976, p.6, col. 5 (Sup. Ct., N.Y. Co., Feb. 23, 1976), and in the other case, a short-form cash merger following a cash tender offer, Tanzer Economic Associaties, Inc. v. Universal Food Specialties, Inc., N.Y.L.J. Mar. 15, 1976 p. 7, col. 1 (Sup. Ct., N.Y. Co., Mar. 11, 1976). While not precedents for Rule 10b-5 purposes, the very well reasoned New York decisions do much to restore rationality after the confusion caused by the poorly reasoned and badly written Second Circuit decisions. Indeed, in rejecting en banc reconsideration of Concord Fabrics and Sante-Fe, the Second Circuit has recognized the importance of the issue and has expressly requested Supreme Court review.

Universal Food involved the acquisition of Libby, McNeil & Libby, a Maine corporation, by Nestle, a Swiss corporation. Nestle first acquired an interest in Libby in 1960 and over the years had increased its ownership to 61%. The increase in ownership was attributable in large part to Nestle's providing needed additional capital to Libby. Libby and Nestle were both public corporations -- Libby being traded on the New York Stock Exchange and Nestle being traded on the principal European stock exchanges. In 1975 Nestle determined to acquire 100% ownership of Libby and Universal Food Specialties (UFS), a wholly owned subsidiary of Nestle, was selected as the vehicle for a tender offer to be followed by a cash merger.

Nestle retained the investment banking firm of Lehman Brothers to evaluate the tender offer price. Lehman Brothers' valuation was $8.125, as compared to a $4.875 market price and a book value of $15.77. Lehman Brothers' opinion was based on a review of Libby's

(1) finances,
(2) competitive position in its industry,
(3) future operating prospects,
(4) price earnings multiples,
(5) relationship of market price to book value, and
(6) liquidation value.

On the basis of the Lehman Brothers valuation, Nestle announced a cash tender offer at $8.125 per Libby share. The tender offer set forth Nestle's intention for a second step short-form cash merger under Maine law at the same $8.125 price, if Nestle were to own more than 90% of Libby after the tender offer. The tender offer also described the appraisal rights available to Libby shareholders under Maine law. The court characterized the tender offer price in these words -- "there is no palpable or gross undervaluation, which on its face would shock the conscience of the Court." The tender offer made full disclosure with respect to Libby, Nestle and UFS. The tender offer resulted in Nestle owning 92% of Libby.

The tender offer resulted in litigation, including the instant case, attacking the adequacy of the $8.125 price. Plaintiff in the instant case then amended the complaint to seek to enjoin the contemplated merger and sought a preliminary injunction. On the argument of the preliminary injunction motion the court approved Nestle sending a letter to the Libby shareholders stating that the Libby-UFS cash merger was intended to be consummated in 30 days, describing the statutory appraisal rights and procedures for shareholders of Libby who objected to the $8.125 price, and setting forth the usual financial and business information about Libby. The apprasial proceedings were to be conducted at Nestle's expense. The purpose of the merger was described as follows:

> "The purpose of the Merger is to complete the acquisition by Nestle and its affiliates of all equity interests in Libby. By acquiring all such equity interests, Nestle will be in a position to enhance Libby's role as a viable competitor in United States and foreign markets by integrating and rationalizing Libby's operations with Nestle's other operations for maximum overall efficiency and profitability, without being inhibited by potential claims of conflict of interest by shareholders of Nestle or Libby for the necessary reallocation of business opportunities, tax benefits and managerial, administrative and financial support and services among Libby and other Nestle affiliates in the United States and elsewhere."

These purposes were amplified by the court to encompass,

> "(1) improved management and corporate planning (since greater resources become available);
> (2) existing management experience in Nestle and Libby will be mutually available;
> (3) savings will result from economics in centralized procurement of raw materials;
> (4) there will be marketing economy in joint distribution, warehousing and advertising;

(5) duplication of departments and personnel can be avoided;
(6) a greater diveristy of products would result in the evening out of cyclical demand;
(7) both companies will be in a stronger financial position with fewer problems in outside financing and with the facilitation of a more efficient cash flow;
(8) in embarking on plans and programs, there will be no concern about possible conflicts of interest between Libby and Nestle; and
(9) without public shareholders the company would not be subject to charges of over-reaching or unfairness to the minority, and would eliminate all the time, expense and energy incurred in connection with stock transfers, dividends, proxy notices, annual reports, SEC compliance and the attendant legal problems."

Plaintiff's motion for a preliminary injunction was predicated on the argument

> "that the minority shareholders will suffer irreparable injury in being deprived forever of their equity position in Libby, that monetary damages will not adequately compensate them for their loss, and that an injunction is justified because the so-called "squeeze out" is unjust, fraudulent, a breach of defendants' fiduciary obligations, and without proper business purpose."

Plaintiff relied heavily on the Concord Fabrics and Santa-Fe cases.

The Universal Food court distinguished Concord Fabrics on the ground that there the inside group went public at a high price and then, without a valid corporate purpose, sought to go private at a low price, and distinguished Santa-Fe on the basis that there the decision was on a motion to dismiss so that the court was forced to assume the allegations of no valid corporate purpose and gross undervaluation and on the further ground that there there was no prior notice of the merger so that the minority shareholders had no opportunity to seek injunctive relief.

The Universal Food court recognized and avoided the logical fallacies and semantic traps to which the courts in many of the going-private-type cases have fallen prey. The court first recognized that modern business and financial practice requires rejection of *per se* proscription of freeze-outs -- "there is no inherent or constitutional right of a stockholder to preserve his status forever." The court then recognized that the Concord

Fabrics type of going private case may involve the kind of overreaching and extreme shareholder and press reaction that must be remedied in order to maintain public confidence in the securities markets. Thus the court concluded that while statutory appraisal should be the exclusive remedy in most freezeout cases, there should be an injunction saftey valve for the cases of gross overreaching by insiders. The court astutely recognized that the private condemnation argument which led the court in Jutkowitz v. Bourns, (Cal. Super. Ct., No. 000268, Nov. 19, 1975) to adopt a per se proscriptive approach merely substitutes a rule of minority tyranny. The court said:

> "In passing upon whether these additional requirements [valid corporate purpose and absence of fraud or breach of fiduciary duty] are to be imported into the proceedings, the court at the outset must be wary of acting precipitously to upset a procedure which has been given express legislative sanction because of an emotional reaction or instinctive predisposition to sympathetic presentation. Skill in choosing appropriate semantic labels may foreshadow the outcome. The claim of 'freeze-out' by a predatory majority using their power as insiders to mulct corporate funds and to overreach in order to unjustly enrich themselves tends to lead a sympathetic court to look indulgently upon extra-statutory remedies.
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> "The obverse of the minority claim, however, may well be that an obdurate and obstrunctionist minority is engaged in a 'hold-up' of legitimate majority desires, motivated solely by greed for the top dollar obtainable. The crime of 'self-interest' is always attributable to the other side. How the court reacts emotionally to a linguistic barrage or to a sympathetic factual presentation should not be the determinant. Objective adherence to the law should avoid both the 'creative' distortion of remedies and the automatic stamp of approval of that which is manifestly inequitable. Whether a picture is presented of malevolent piracy or of beneficent paternalism must be decided on the facts of each case, and not on the ready application of labels."

Essentially the Universal Food court limited the supplementation of the statutory appraisal remedy to those cases where there is no valid corporate purpose for the freezeout:

> "What, then, is the business purpose of the merger, and why must it be demonstrated? The 'why' is readilly answerable. Meticulous compliance with statutory requirements can still be the device for unfair dealing, human ingenuity being what it is. If the takeover represents nothing more than a naked grab for power, with no further justificiation, that, in and of itself, may be one of the telltale signs of overreaching. That overreaching may be fraud, in its original common law sense of deception and concealment, or it may be some other species of chicanery. The presence of a legitimate corporate business purpose, over and above the self-interest of the investors, tends to negate the 'raiding' or the 'milking' which might justify the courts' equitable intervention."

The rejection of a per se proscription of freezeouts and the formulation of the corporate purpose test by the court in Universal Food as a trigger for consideration of injunctive relief distinguishes between second-step acquisitions and insiders going public at a high price and going private at a low price -- the former will almost always involve the combination of two businesses and therefore the kinds of corporate purposes identified as valid by the Universal Food court; the latter will rarely entail corporate purposes other than saving the expenses of being public and permitting private-company-type compensation of executives, which may indeed be "valid" purposes in some special cases but which generally can be recognized as weak excuses for insider "grabs".

In distinguishing the Concord Fabrics and Santa-Fe cases, the Universal Food court indicated that absent direct use of a corporation's funds to enable the insiders to take it private (such as in Concord Fabrics) the utilization of the corporation's assets subsequent to the merger is not material and that notice to the minority shareholders prior to effectuation of a short-form merger may be significant. In Cerro the court found significant the fact that the terms of the merger were approved by a committee of independent directors and substantial minority shareholders, and that the long-form merger there involved required a vote of all the shareholders with the acquiring parent having deferred the determination to the public shareholders by agreeing to vote its shares to approve the merger only if a public majority so approved. In both Universal Food and Cerro, the merger terms were based on reports by prominent investment bankers and while both cases involved merger terms at substantial discounts from book

value, they involved substantial premiums over market and no indication of manipulation. The Universal Food court said: "The niceties and discrepancies of any possible price adjustment should appropriately be left for the appraisal proceedings." While paying lip service to the denial by the Sante Fe majority that mere gross undervaluation was sufficient to establish a Rule 10b-5 violation, both the Universal Food and Cerro courts made special note that the merger price in Sante-Fe was $150 as compared to a $772 asset value. The Universal Food court also indicated rejection of the "fair-share" of future benefit approach advocated by Brudney & Chirelstein, Fair Shares in Corporate Mergers and Take Overs, 88 Harv. L. Rev. 297 (1974). The court said: "Once the holdings of any investor cease, he yields his claim to a share in the future."

The decision in Universal Food and Cerro together with the decisions in Bourns; Berkowitz v. Power/Mate Corp., 137 N.J. Super. 36 (Ch. Div. 1975) (indicating that a going public high, going private low case would run afoul of an implied corporate purpose requirement); People v. Concord Fabrics, Inc., 83 Misc.2d 120, aff'd 373 N.Y.S.2d 84 (App. Div. 1st Dept. 1976) (applying the New York Blue Sky law to the Concord Fabrics situation); and Harriman v. E.I. DuPont de Nemours and Co., [Current] CCH Fed. Sec. L. Rep. ¶ 95,386 (D. Del. Dec. 23, 1975) (Delaware would apply the intrinsic fairness test -- careful scrutiny by the court with the proponents having the burden of showing fairness -- to a going-private-type transaction and post-merger gain-sharing might be an appropriate factor in valuation to "artificially provide the otherwise missing arms-length bargain") demonstrate that the state courts have been and can be innovative and adept at distinguishing between the various types of freezeouts and that there is no need for the intervention of federal securities law; certainly not per se proscription under Rule 10b-5. In Cort v. Ash, 43 U.S.L.W. 4773 (June 17, 1975) and Bangor Punta Corp. v. Bangor & Aroostock R.R., 417 U.S. 703 (1974) the Supreme Court rejected expansion of implied remedies under federal law to regulate corporate management. In Cort v. Ash 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."

It is hoped that the Supreme Court will either return Rule 10b-5 to its pre-Concord Fabrics and Sante-Fe concern only with disclosure or at the very least show the discrimination of the New York courts in reject-

ing a per se approach to freezeouts. Until the Supreme Court acts, except for those situations where the existence of a corporation is threatened by the expense of being public or the freezeout price is greater than both market price and asset value, the Concord Fabrics-type going private transaction should not be attempted. Santa Fe-type second-step acquisitions would meet the Second Circuit Rule 10b-5 requirements if the Cerro procedures are followed.

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