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To Our Clients

Conflict Mergers - Fairness

Mills v. Electric Auto-Lite Co., CCH ¶ 96,035 (7th Cir. 1977) promises to be a leading case on the issue of fairness in conflict (parent-subsidiary) mergers.

First, the court held that the ratio of the average market prices of the parent and the subsidiary (the court found that such market prices in this case reflected a free market that was not tainted by the parent-subsidiary relationship or the trading activities by the parties) during the six-month period preceding the merger agreement is the dominant criterion to be applied in determining the fairness of the merger ratio. The court rejected going back beyond six months and rejected major emphasis on earnings, book value, dividends, and other "qualitative" factors. The court said:

> ". . . Since prices from the period immediately preceding the merger are the most likely to reflect the actual value of each corporation at the time the merger was consummated, we begin with a presumption that a short period is appropriate. Accordingly, we hold that the average market value for approximately the six month period preceding the merger should be used unless there are special factors indicating that this period is unreliable. Six months is long enough so that very short term price fluctuations will not play an unfairly important role and short enough so that the calculated ratio does not reflect business conditions that have substantially changed as of the time of the merger."
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> "We hold that when market value is available and reliable, other factors should not be utilized in determining whether the terms of a merger were fair. Although criteria such as earnings and book value are an indication of actual worth, they are only secondary indicia. In a market economy, market value will always be the primary gauge of an enterprise's worth. In this case thousands of shares of Auto-Lite and Mergenthaler were traded on the New York Stock Exchange during the first part of 1963 by outside investors who had access to the full gamut of financial information about both corporations, including earnings and

> book value. If we were to independently assess criteria other than market value in our effort to determine whether the merger terms were fair, we would be substituting our abstract judgment for that of the market. Aside from the problems that would arise in deciding how much weight to give each criterion, such a method would be economically unsound."

Second, the court held that the minority shareholders of the subsidiary are entitled not just to the ratio determined on the basis of comparative market prices, but to their share of the synergistic effect of the merger. The court adopted the proposition urged by Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 Harv. L. Rev. 297 (1974). The court said:

> "According to the fairness formula devised by Professors Brudney and Chirelstein, the minority shareholders of Auto-Lite should have received Eltra stock worth at least as much as the premerger market value of their holdings in Auto-Lite and a share of the synergism produced by the perger proportionate to the percentage of the combined premerger value of Auto-Lite and Mergenthaler which their holdings represented." . . .

While we disagree with the Brudney & Chirelstein proposition and think that it is bad law and bad economics, it must be recognized that it has received increasing acceptance in the courts. Investment bankers fairness opinions in conflict mergers will have to take into account this growing acceptance and possibility of universal applicability.

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