September 28, 1977

To Our Clients:

Going Private; Long-Form Freezeout Mergers; Delaware Abandons Position that Appraisal is Exclusive Remedy

Despite recent cases in other jurisdictions to the contrary, until September 23, 1977, it was generally assumed that Delaware law was that absent fraud or blatant overreaching a long-form cash merger could be used to freezeout the minority shareholders of a subsidiary even though the freezeout does not serve any corporate or business purpose of the subsidiary and the minority has no voice in determining whether the merger will be effected and the sole remedy of the minority is an appraisal proceeding. This was the direct holding of the Delaware Court of Chancery in Singer v. Magnavox Co., 367 A.2d 1349 (Del. Ch. 1976). However, this decision was reversed by the Delaware Supreme Court which held that a long-form merger, "made for the sole purpose of freezing out minority stockholders is an abuse of the corporate process." Civ. No. 289 (Del. Sup. Ct., Sept. 23, 1977).

The facts of the Magnavox case are important for a full understanding of the decision. The case arose out of a hostile cash tender offer by North American Philips Corp. (NAPC) for all the shares of Magnavox at $8 per share at a time when the market price was substantially less than $8. Magnavox opposed the NAPC tender on the ground that the price was inadequate in light of the $11 per share book value of Magnavox. After the usual skirmishing, management of Magnavox reached an accomodation (two-year employment contracts at their then salaries) with NAPC which resulted in an increase in the tender price to $9 per share and withdrawal of opposition to the tender offer. The tender offer stated NAPC's purpose to acquire the entire equity of Magnavox and intent to acquire any shares outstanding after the tender by merger or other means. The tender offer drew 84% of the Magnavox shares and NAPC took full control of Magnavox. A few months later NAPC caused Magnavox to enter into a long-form cash merger agreement at $9 per share. The corporate action by Magnavox on the merger was taken without the use of a committee of independent directors and without an in-

dependent investment banker's opinion as to fair value. No corporate or business reason for the merger was advanced other than the desire of NAPC to eliminate the minority and to achieve full ownership of Magnavox. The merger was submitted to a vote of the Magnavox shareholders at a special meeting. Since NAPC owned 84% of the shares and did not agree to vote in accordance with the vote of the minority, the minority vote was meaningless and, as a practical matter, the merger was effected by the sole action of NAPC.

The Chancery Court in Magnavox summarized the Delaware law with respect to freezeout mergers as "(1) unless a minority shareholder could show fraud or blatant overreaching on the part of the majority in eliminating his stock interest through merger, the merger itself, and the reasons for it, were not subject to attack, and (2) a merger designed primarily to eliminate minority shareholders was not an improper use of either [the long-form or short-form merger provisions of the Delaware Corporation Law]." The Chancery Court rejected the recent federal and state cases (e.g., Green v. Santa Fe Ind. Inc., 533 F.2d 1283, (2d Cir. 1976), reversed 97 S. Ct. 1292 (1977); Berkowitz v. Power/Mate Corp., 342 A.2d 567 (N.J. Super. 1975); Jutkowitz v. Bourns, Civ. No. 000268 (Cal. Super. Nov. 19, 1975)) that invalidated freezeouts that were not justified by a business or corporate purpose of the subsidiary. The primary basis for rejection was the basic Delaware doctrine that a corporate transaction that is authorized by the Delware Corporation Law is viewed as an independent transaction that does not need any extra-statutory justification -- motive is not significant if the transaction is specifically authorized by statute. In addition, the court noted that Power/Mate and Bourns involved going public high and going private low and said:

> "Admittedly there seems something fundamentally inequitable about such a stark progression of events and perhaps a use of the Delaware statutes should not be permitted which would allow those with controlling interests who originally sought public participation to later kick out public investors for the sole reason that they have outlived their

> utility to those in control and are made easy pickings by existing market conditions. However, if such an exception is to be made it must wait for another day because, according to the complaint, such a situation does not exist here." 367 A.2d at 1358.

The rationale of the Delaware Supreme Court in Magnavox was almost directly opposite to that of the Chancery Court. First the Supreme Court held that the parent in a parent-subsidiary merger has a fiduciary duty to the minority shareholders of the subsidiary and that this fiduciary duty cannot be met "simply by relegating [the minority shareholders] to a statutory appraisal proceeding." In so holding the Delaware Supreme Court accepted the reasoning of the Bourns and Power/Mate cases that a shareholder's rights are more than the mere assurance of fair value when the majority shareholder decides to eliminate the minority interest. This reasoning constitutes a clear retreat from the modern investment concept of share ownership in public corporations back to a property right concept.

The essence of the Delaware Supreme Court decision is contained in these paragraphs:

> "We hold the law to be that a Delaware Court will not be indifferent to the purpose of a merger when a freezeout of minority stockholders on a cash-out basis is alleged to be its sole purpose. In such a situation, if it is alleged that the purpose is improper because of the fiduciary obligation owed to the minority, the Court is duty-bound to closely examine that allegation even when all of the relevant statutory formalities have been satisfied.
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> First, it is within the responsibility of an equity court to scrutinize a corporate act when it is alleged that its purpose violates the fiduciary duty owed to minority stockholders; and second, those who control the

> corporate machinery owe a fiduciary duty to the minority in the exercise thereof over corporate powers and property, and the use of such power to perpetuate control is a violation of that duty.
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> By analogy, if not a fortiori, use of corporate power to eliminate the minority is a violation of that duty, if done without a valid business purpose. Accordingly, while we agree with the conclusion of the Court of Chancery that this merger was not fraudulent merely because it was accomplished without any purpose other than elimination of the minority stockholders, we conclude that, for that reason, it was violative of the fiduciary duty owed by the majority to the minority stockholder.
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> We hold, therefore, that a [long-form] merger, made for the sole purpose of freezing out minority stockholders, is an abuse of the corporate process; and the complaint, which so alleges in this suit, states a cause of action for violation of a fiduciary duty for which the Court may grant such relief as it deems appropriate under the circumstances."

What is left of going private after Magnavox?

1. Magnavox involved a long-form merger. The long-form was necessary because the parent did not own 90% or more of the subsidiary. The opinion is expressly limited to long-form mergers and clearly does not affect short-form mergers. Therefore, Delaware law continues to be that short-form mergers may be accomplished without a business purpose of the subsidiary and absent fraud or blatant overreaching, appraisal is the exclusive remedy of the minority shareholders. Accordingly, successive tender offers or other voluntary acquisitions of shares followed by a short-form merger may continue to be used to eliminate minority ownership.

2. Magnavox involved a cash freezeout, not an equity security merger. While the opinion is not clear, based on the repeated use of "cash-out" by the Court, it appears that this is a distinction that the Delaware Supreme Court may accept. It is, of course, much easier to find (or construct) business purposes when the minority shareholders continue to have an equity interest in the combined enterprise.

3. Despite a dissent which criticized the failure, the Delaware Supreme Court in Magnavox refused to deal with the question whether the requisite business purpose is that of the parent or the subsidiary and instead rendered a very narrow opinion on the conceded fact of no business purpose. This at least leaves open the possibility that Delaware would accept the elimination of conflicts and benefits of centralization business purposes accepted in New York in Tanzer Economic Associates, Inc. v. Universal Food Specialties, Inc., 383 N.Y.S.2d 472 (Sup. Ct., N.Y.Co. 1976).

4. The absence of the now customary procedures for assuring fulfillment of fiduciary duties in conflict situations, while not specifically mentioned, clearly was the underlying rationale of the Magnavox decision. We believe that the result would have been different if the merger had been approved by a committee of independent directors upon the advice of an independent investment banker that the terms were fair from a financial standpoint to the minority shareholders and if the merger was structured so that it would have been approved only if a majority of the minority shareholders voted in favor.

While Magnavox makes going private more difficult, in our opinion going private is not dead. We think the courts will continue to recognize the practical business, financial and economic advantages of going private and will continue to permit going private transactions which are accomplished with the appropriate safeguards of the rights of the minority shareholders noted above.

Magnavox emphasizes that the minority shareholder freezeout is the most sensitive of corporate transactions and should only be undertaken in compliance with procedures designed to assure the establishment of complete discharge of the parent's fiduciary duty to the minority shareholders of the subsidiary.

M. Lipton