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To Our Clients:

Freezeouts

Two recent cases indicate that the courts are not as hostile to freezeouts as is generally assumed. With the growing popularity of leveraged buyouts and the continuing activity in second-step freezeouts following tender offers, this continues to be an area of great importance to investment bankers and lawyers.

Tanzer v. International General Industries, Inc., Civ. No. 4945 (Del. Ch. May 10, 1979) is the first case to discuss in detail the elements of the Delaware "entire fairness" doctrine first applied to freezeouts by the Delaware Supreme Court in Singer v. Magnavox Co., 380 A.2d 969 (Del. Sup. Ct. 1977). In Singer, the Delaware Supreme Court said that dissenters' appraisal rights were not the exclusive remedy in a freezeout and that the entire fairness doctrine required that the trial court examine all elements of a freezeout, including the business purpose. Shortly thereafter, in an appeal from an earlier holding in the Tanzer case, the Delaware Supreme Court held that a business purpose of the parent company effecting the freezeout (facilitation of financing by the parent) was a sufficient business purpose to satisfy that aspect of the entire fairness doctrine.

Unfortunately the Tanzer decision is the product of cross motions for summary judgment and the shareholder plaintiffs did not present evidence as to the "fairness" of the price. Therefore the opinion does not fully address the question of what valuation factors must be taken into account in determining a "fair" price to the minority shareholders. Except for this aspect, the decision is a roadmap for a going private transaction and is worth considering in detail.

The basic facts in Tanzer fall into the typical pattern. The defendant parent company, I.G.I., sold 18% of a wholly-owned subsidiary, Kliklok, to the public in 1965 at $11 per share. Kliklok had a nondistinguished record on the American Stock Exchange, failing to reach $11 per share in 1973 or 1974 or in 1975 prior to the September 1975 announcement that I.G.I. was studying a freezeout. The freezeout was effected by I.G.I. merging a shell corporation, KLK, with Kliklok so that I.G.I. upon the merger would own 100% of Kliklok and the public shareholders would receive $11 cash. The freezeout price of $11 was recommended by Dillon Read, the

investment banker for I.G.I. The $11 price was 99.5% of Kliklok's book value at June 30, 1975, and represented 6.7 times 1974 earnings, 7.5 times the 12-month earnings for the period ending June 30, 1975, 9.2 times estimated 1975 earnings and 9.0 times the average earnings for 1971 through 1975. The $11 price was a premium of 29% over the market price on the day prior to the announcement of the freezeout and 36% over the average for 1975 to that date. There was no issue raised as to full disclosure in the merger proxy statement. The funds for the cash merger were derived from a loan that became a Kliklok obligation on the merger. The Kliklok minority shareholders who dissented from the merger had appraisal rights under the Delaware statute. I.G.I. stated that it would vote for the merger and therefore the merger vote was assured no matter what the vote of the Kliklok minority shareholders. Over 50% of the outstanding minority shares were voted in favor of the merger, and almost 90% of the minority shares actually voting were voted in favor of the merger. The court held that in light of the prior proceedings in this case the burden of proof was on I.G.I. to demonstrate entire fairness, but that the issue was open as to whether in other cases approval by a majority of the public shareholders would shift the burden of proof to the shareholder attacking the freezeout. As noted below, the court did not consider the parent being able to force the freezeout by its own vote to be a violation of the entire fairness doctrine.

The <u>Tanzer</u> court discussed eight criteria of fairness.

1. <u>Business purpose</u>. The court held it was bound by the prior decision of the Delaware Supreme Court that facilitating financing by the parent for the parent's business was a sufficient business purpose to satisfy this aspect of the entire fairness doctrine. Logically business purpose should play no part in determining the fairness of a freezeout. However, many of the courts that have considered freezeouts have mentioned business purpose or the lack thereof as a significant factor in the decision. Accordingly, a business purpose should be an element of a well-structured freezeout and as long as the courts will accept purposes such as facilitating financing by the parent or eliminating potential conflicts no difficulty will be encountered. However, it should be kept in mind that it is better to litigate the issue whether a business purpose is essential, than to structure a freezeout on a spurious business purpose.

2. <u>Cash freezeout rather than common stock merger</u>. The court refused to accept the argument that where the parent effecting a freezeout is a public company it should be required to use common stock rather than cash as the consideration in the

freezeout. However, the court went on to say that, where feasible, consideration should be given to structuring freezeouts with an option to the minority shareholders to take cash or stock. Implicit in the court's discussion of this point is the assumption that the cash consideration and the market value of the stock in such an optional consideration freezeout need not be the same.

3. Investment banker's opinion. As noted above, Dillon Read acted as investment banker for I.G.I., not the public shareholders of Kliklok. Dillon Read had a $200,000 fee that was dependent on the freezeout going through. Indeed, the SEC raised an issue as to whether Dillon Read was independent and suggested that a second opinion be obtained; which suggestion was declined. The court held that this lack of independence did not as a matter of law result in the freezeout violating the entire fairness doctrine. Instead the court considered the facts taken into account by Dillon Read and held that in the absence of contrary evidence they established that the price was fair.

A well structured freezeout should be based on an investment banker's opinion and should not rely on Tanzer with respect to the "independence" of the investment banker. The investment banker should be retained by the board of directors of the subsidiary (or a committee of disinterested directors) and should be charged with opining on a fair price to the public shareholders. The investment banker's compensation should not be contingent other than the customary two-tier fee structure depending only on whether the opinion is used in a disclosure document.

Because the attacking shareholders presented no evidence as to valuation, the Tanzer opinion leaves unanswered the key question whether an investment banker must consider the price at which the company could be sold to a third party in an arms-length transaction (even though there is no intention of so selling the company) in reaching an opinion as to a fair price to the minority shareholders. The Tanzer court refers primarily to the premium over the average market price during the two years preceding the announcement of the freezeout and the price earnings ratio based on the average earnings for the five years prior to the freezeout. As set forth below, the Tanzer court rejected the "fair shares" argument that the synergistic effect of the freezeout or the benefit of 100% ownership to the parent should be a valuation factor.

If, as the undersigned reads the opinion, the Tanzer court did in fact intend to approve freezeout valuations that do not take into account the price at which the company could be sold to a third party, this would be a very significant holding. It would be a modern reaffirmation of old case law which ignores or discounts third-party-sale value; case law which we believe is outmoded and would not be followed today if a court was directly faced with the question. It should be remembered that in the Woods case the SEC held that it was a violation of the proxy rules not to disclose that an investment banker's freezeout opinion did not take into account sale to a third party or liquidation value. Being a disclosure case, Woods did not hold that anything less than third-party-sale or liquidation value would be unfair.

We believe that except in unusual situations, investment bankers should not give limited fairness opinions in going private transactions. The investment banker should consider historical market prices, investment value and liquidation or third-party-sale value. The investment banker should perform the due diligence review (and if appropriate obtain the advice of other experts) necessary to form an opinion as to each of the three traditional elements of value -- market value, investment value and third-party-sale or liquidation value. The ultimate determination of fairness is then a judgment based on the three elements and the banker's opinion as to current economic and financial conditions. In freezeouts third-party-sale or liquidation value should not be discounted or ignored on the ground that the controlling insiders would not sell or liquidate; it should be taken into account along with the other valuation factors and in appropriate cases should be the principal factor.

4. Adequate notice to the minority shareholders. The court held that the mailing to the shareholders of a SEC processed proxy statement 30 days prior to the freezeout meeting met the requirement of full disclosure and adequate notice. Where a short form merger is possible and therefore no prior notice to the minority shareholders is necessary, it is suggested that the freezeout be structured as if a shareholders meeting was being held and a full information statement be sent to the shareholders at least 20 days prior to the date the short form merger is to be effectuated.

In Tanzer the minority shareholders were not given the now frequent right to determine by a vote of a majority of the minority whether or not the freezeout should take place. The court did not discuss whether this was required under the entire fairness doctrine. Since the entire fairness doctrine has been held to apply to short form merger freezeouts, the lack of necessity of deferring the vote to the minority may be of considerable significance. See the Bromberg case below.

5. Going public high, going private low. The court rejected the argument that it is inherently unfair to permit a controlling person to take a company public at a high price and then take it private at a low price. The court said:

> It is clear that the 1965 offering price has no relevance to the fairness of the merger price in 1975. By analogy, to appraisal proceedings, the Court must look only at prices at or shortly prior to the merger in fixing a market value. Levin v. Midland-Ross Corp., Del. Ch., 194 A.2d 50, 53-54(1963) (average of prices on last trading day preceding announcement of merger); In re: Olivetti Underwood Corp., Del. Ch., 246 A.2d 800 (1968) (prices for five-month period prior to tender offer). The market price for Kliklok shares 10 years before the merger simply has no probative value in establishing a fair price for such stock in 1975.

6. Use of subsidiary's own funds to finance the freezeout. The court rejected the argument that financing a freezeout through the subsidiary's assets is unfair. The court said that once the freezeout is effected, it does not matter whose assets have been used to finance the price or who is paying the interest on funds borrowed to pay the price.

7. Existence of appraisal rights. While Singer departed from the theretofore understood Delaware position that appraisal rights satisfied the obligation of the parent to the minority shareholders in a freezeout, the Tanzer court held that the availability of appraisal rights should be taken into account, however, as one factor in assessing whether a transaction between a parent corporation and its subsidiary's minority stockholders is entirely fair, even though its existence alone is insufficient to establish that the transaction was fair.

8. Fair shares. The Tanzer court rejected the "fair shares" argument put forth in Brudney and Chirelstein, Fair Shares in Corporation Mergers and Takeovers, 88 Harv. L. Rev. 299 (1974). The court said:

> The allocation of part of the value of the synergistic effect to the minority being forced out has been approved in but one case, as far

as I am aware. In Mills v. Electric Auto-Lite Co., 7th Cir. 552 F.2d 1239 (1977); Cer. den. 434 US 922, 434 US 1002, the Court approved the principle but concluded that the minority stockholders received a premium in excess of the value of the synergistic effect. The compulsory allocation of the value of the synergistic effect to the frozen-out minority stockholders in a merger assumes that in all mergers there will be a value to the surviving corporation of the merger itself. This ignores the fact that many mergers have not turned out that way. Often the surviving corporation is not stronger or more profitable than its parts.

The greatest difficulty with adopting a rule requiring a premium to be paid to the minority because of the possible synergistic effect of a merger is the highly speculative nature of the effect. The probable existence of the synergistic effect would usually have to be determined before the merger in a case such as this where an injunction against the merger was sought. As a matter of practicality, it is almost impossible to ascertain the financial benefits, if any, which will occur solely because of the merger. The fact that the merger would not take place if the authors of the merger did not think it had merit does not establish that it will be profitable.

The only practical time to consider the synergistic effect, if any, would be during an appraisal pursuant to 8 Del. C. §262. Unfortunately, the Delaware appraisal statute presently precludes its consideration. It is not for this Court, however, to substitute its judgment for that of the General Assembly. If the synergistic effect is to be considered by this Court in an appraisal proceeding, it should be legislatively mandated.

More importantly, however, in the present case is the fact that the Tanzers have introduced no evidence that the 29% premium offered by I.G.I. for the Kliklok stock owned by the minority stockholders does not adequately compensate the minority stockholders for any possible synergistic effect.

Bromberg v. Stern., No. 19153/78 (Sup. Ct., N.Y. Co., Feb. 16, 1979) refused to enjoin a cash freezeout of the public shareholders of Hartz Mountain Corp. that was structured on the following basis:

(1) The controlling majority shareholder agreed to vote for the merger only if a majority of the public shareholders approved.

(2) Even though the state law did not provide for dissenters' appraisal rights in cash mergers, the transaction was structured so that a simultaneous charter amendment accorded such rights.

(3) The freezeout price was based on the opinion of an independent investment banker who considered among other things "the public trading record of Hartz, financial information and the record of securities trading of certain companies it deemed comparable to Hartz, and the terms of various recent tender offers, mergers and similar transactions".

(4) The business purpose was to facilitate the parent's ability to finance its business.

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