Fairness in Delaware Freezeout Transactions: How Two Discrepant Legal Standards Affect Valuations

GILBERT E. MATTHEWS, CFA &
MICHELLE PATTERSON, JD, PhD

Sutter Securities Incorporated
San Francisco, CA
gil@suttersf.com

Delaware courts are currently applying two discrepant legal standards of fairness to freezeouts of minority shareholders. This article addresses their development and their impact on fairness opinions and valuations.

CONTRASTING STANDARDS OF FAIRNESS IN FREEZEOUTS

When control shareholders ("controllers") take a company private by acquiring all the shares held by minority public shareholders, the transaction is described as a freezeout.[1] The two common formats for control shareholders of Delaware corporations to effectuate a freezeout are (a) the traditional one-step negotiated long-form merger ("negotiated freezeouts") and (b) the newer two-step freezeout structured as a tender offer followed by a short-form merger ("freezeout tender offers"), which began being used in 2001.

Under current Delaware law, different standards of legal review for fairness are applied to these two forms even though their function—taking a company private— is the same.[2] Paradoxically, a controller who undertakes the traditional long-form freezeout and negotiates the merger terms with the target's independent directors is held to a higher standard of fairness than when the controller chooses to act unilaterally via a short-form freezeout tender offer.

The standard for the negotiated going-private transaction is a "strict scrutiny" review for "fairness" called "Entire Fairness." This review is both broad and exacting. The Court looks at the fairness of the entire transaction by assessing not only whether minority shareholders were dealt with fairly — "fair dealing"— but also whether they received a "fair price" for being frozen out of their shareholdings. "Fair dealing" involves how the transaction was timed, initiated, structured, negotiated, disclosed and approved and "fair price" includes all elements of value[3] (see discussion of Entire Fairness below).

"Entire Fairness" ("fair dealing plus fair price") review is friendlier to minority shareholder plaintiffs than the "Business Judgment Rule" review, which the Chancery Court has held to be the appropriate standard for the newer freezeout tender offers. The combined effect of two 2001 decisions, one by the Supreme Court in *Unocal Exploration*[4] and the other by the Court of Chancery in *Siliconix*,[5] was to make it possible for a control shareholder to avoid the negotiated freezeout's Entire Fairness standard by choosing the two-step freezeout tender offer. The Supreme Court has not yet ruled on whether controllers who use this new format get to avoid entire fairness scrutiny. The Supreme Court, in fact, "has never had an occasion to rule on the issue of what equitable standard of review applies in a tender offer freezeout."[6] Nevertheless, transaction planners and controllers, relying on the Court of Chancery's decisions, are increasingly availing themselves of this newer form of freezeout.

The Business Judgment Rule is considered "deferential" to corporate management because, under this standard, courts commonly defer to directors' and officers' judgment. When Business Judgment is applied, the freezeout is reviewed *only* in terms of "fair dealing," not "fair price." This narrower scope makes it difficult for plaintiffs to challenge the transaction. Thus, the Business Judgment review applied in the unilateral freezeout tender offer is friendlier to the controller. As a result, control shareholders are utilizing the freezeout tender offer format with increasing frequency in order to "freeze out" minority shareholders and achieve 100% ownership.

ENTIRE FAIRNESS IS THE SETTLED AND EXCLUSIVE STANDARD OF REVIEW FOR NEGOTIATED FREEZEOUTS

In 1994, the Delaware Supreme Court ruled in Lynch[7] that the stringent Entire Fairness test is the exclusive standard of review when a controller acquires the minority's shares through a negotiated freezeout, because it views these transactions as "presenting a risk of self-dealing by controllers.[8] Indeed, the Delaware Courts

> ...have long reviewed minority shareholder challenges to such pre-approved freeze outs under the exacting "entire fairness" standard *[footnote omitted]*, reasoning that conflicts of interest faced by the controlled corporation's board of directors (who approve the transaction on the minority's behalf), along with the controlling shareholder's coercive capabilities, preclude application of the more deferential business judgment form of review. [9]

Continued on next page

expert TIP

Given Delaware's prominence in case law in the appraisal industry, an understanding of "fairness" in freezeout transactions could be important.

Moreover, in these freezeouts, the controller is often able to take the company private by voting its majority shares in favor of the merger without *any* vote by the minority.

Under Entire Fairness, there is an important shift in the ordinary litigation process that works to the advantage of the minority shareholder plaintiff. In most litigation, the plaintiffs bear the burden of proving their case. In contrast, with Entire Fairness, controller defendants have the burden of showing that their transactions were, in fact, fair. The law imposes this burden because the controller is seen as a conflicted, interested party. Nevertheless, there is a way for the controller to shift the burden back to the plaintiff. There is an "established equitable practice of allowing ratification by disinterested directors … to insulate a self-dealing transaction from strict scrutiny for fairness *[footnote omitted].*"[10] If disinterested directors approve a corporate action, the Courts usually allow the business action to be reviewed under the deferential Business Judgment Rule. However, because of the Courts' concern regarding mergers by control parties, *even if* disinterested director approval is present, the review for fairness in negotiated freezeouts remains the broader Entire Fairness.

The courts, however, recognize under Entire Fairness the potentially minority-protective value of independent director and shareholder ratification, and afford the controller who provides for these in its transaction the benefit of being able to shift the burden of proof back to the plaintiff. The controller must show that its negotiated freezeout included *either* of two procedural safeguards:

(a) a special committee of independent directors of the subsidiary with the ability to block the transaction (independent committee approval) or

(b) a condition that an informed majority of the minority shareholders approve the transaction (majority of the minority approval).

Since a minority shareholder's challenge remains under the Entire Fairness standard, the Chancery Court must undertake a comprehensive and stringent review of price and dealing with no possibility for an early dismissal of the case. Thus, a defending controller cannot avail itself of the Business Judgment Rule regardless of what procedurally fair steps it follows in its freezeout transaction.

FREEZEOUT TENDER OFFERS ARE SUBJECT TO BUSINESS JUDGMENT RULE REVIEW IF NONCOERCIVE AND IF DISCLOSURE IS ADEQUATE

Freezeout tender offers have become more popular since the Chancery Court ruled that they will be reviewed under the Business Judgment Rule rather than Entire Fairness unless the offer is coercive or material information is withheld (as discussed below). The Supreme Court in *Unocal Exploration* (2001) clarified the standard for review for short-form mergers, ruling that for short-form mergers, appraisal is the exclusive remedy available to a minority stockholder complaining of unfairness. The Court of Chancery ruled in *Siliconix* that the Business Judgment Rule applied to a freezeout tender offer. The combined effect of *Unocal Exploration* and *Siliconix* was to enable a control shareholder to avoid the more exacting Entire Fairness standard applicable to a negotiated transaction by using the two-stage freeze-out process: a tender offer for enough outstanding shares to attain 90 percent ownership, followed by a short-form merger.

Neither Entire Fairness Nor the Business Judgment Rule Is Applicable to Short-Form Mergers—Minority Shareholders' Only Remedy is Appraisal

Delaware General Corporate Law §253 authorizes the corporate owner of 90 percent or more of the voting stock of a company to merge the subsidiary into itself without any requirement that the subsidiary's board of directors approve the merger (a "short-form merger").[11] *Unocal Exploration* held that Entire Fairness was not applicable to short-form mergers conducted under §253. The Supreme Court took note of the fact that a parent corporation and its directors are self-dealing fiduciaries who, under settled principles, would be required to establish Entire Fairness in a freezeout transaction, but said that §253, as written by the Legislature, does not hold them to do so. The Court acknowledged that §253's merger procedure is inconsistent with customary notions of fair dealing.

> In a short-form merger, there is no agreement of merger negotiated by two companies; there is only a unilateral act - a decision by the parent company that its 90% owned subsidiary shall no longer exist as a separate entity. The minority stockholders receive no advance notice of the merger; their directors do not consider or approve it; and there is no vote. [12]

Because minority shareholders are not entitled to an Entire Fairness judicial review, they are not entitled to the equitable remedies that an Entire Fairness review provides. The Court held that "absent fraud or illegality, appraisal is the exclusive remedy available to a minority stockholder who objects to a short-form merger."[13]

Business Judgment Rule, Not Entire Fairness, Is the Standard for Noncoercive Freezeout Tender Offers

Also in 2001, a Chancery Court case provided the answer to the question of what the standard of judicial review for fairness would be if a controller combined a tender offer with a short-form merger to take a company private — the tender offer freezeout. Vice Chancellor Noble ruled that the control shareholder could acquire minority shares in a tender offer without the recommendation of the sub-

Continued on next page

sidiary's board of directors. He concluded that the controller had no duty to demonstrate Entire Fairness unless coercion or disclosure violations occurred, and that the appropriate standard of review was Business Judgment accompanied by the usual fiduciary duties imposed on controlling parties. However, Entire Fairness would be invoked if the offer were "coercive."

Vice Chancellor Strine subsequently defined "coercive" in *Pure Resources* (2002), ruling that a freezeout tender offer would be deemed coercive unless

(a) it was subject to a non-waivable condition that no shares would be accepted unless an informed majority of the minority tendered,
(b) the controller committed to a prompt short-form merger at the same price if it reached 90 percent ownership, and
(c) there were no threats of retribution if the offer was not accepted.[14]

Strine later made clear in Cox (2005) that a coercive tender offer could be subject to Entire Fairness if the controller did not conduct the transaction in conformity with a high level of fiduciary duty. He said that a noncoercive tender offer "requires the equivalent of an informed, uncoerced majority of the minority vote condition for a controller to avoid entire fairness review."[15]

Strine also ruled in *Pure* that (a) the target company should be allowed and enabled to set up an independent director committee, (b) the committee should review the controller's merger terms and make a recommendation, and (c) disclosure should include a summary of the substantive work performed by the financial advisor.[16] Strine's ruling has resulted in increased use of financial advisors in this form of freezeout.

IMPACT OF FAIRNESS STANDARDS ON VALUATIONS

When a controller proposes a going-private transaction, independent directors customarily retain financial advisors to value the minority shares and to render fairness opinions, thereby assisting the directors in carrying out their fiduciary duties. Delaware courts have recognized the value to independent directors and shareholders of fairness opinions and their underlying valuations. Indeed, the courts view the obtaining of these opinions as evidence of the directors' fulfillment of their obligations.

The financial advisor must consider the format of a Delaware freezeout that is being valued because the standard of fairness that will be applied affects the value of the minority shares. The remedy available to minority shareholders who believe that the price offered is inadequate also impacts fairness.

Fairness Opinions and Valuations in Negotiated Freezeouts

As discussed above, a negotiated freezeout is subject to Entire Fairness. The remedy for minority shareholders as a class is to receive "fair price," which the Supreme Court defined in *Weinberger* as "all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."[17] This decision enabled the valuator to use forward-looking valuation methods in Delaware courts, and to use valuation approaches generally used by practitioners rather than the outmoded Delaware Block Method.

The valuation for a fairness opinion in a negotiated freezeout is similar to the analysis that a valuator undertakes for an arms'-length transaction with a third party with one exception. The exception is that the valuator should not apply a control premium to the minority shares because the controller already has control. The control premium to be excluded is an amount that a buyer would pay for an entire company in excess of its going-concern value as an independent business. The valuator should include a premium over market (the reciprocal of a minority discount) to the extent that it reflects the elimination of discounts for minority interest and lack of marketability.

Even if the procedures followed by the controller and the independent directors have succeeded in shifting the burden of proof to plaintiffs, the Court of Chancery will, in its Entire Fairness review, consider the fairness of the price. If there is a class action challenging fairness, all minority shareholders included in the class will receive the benefit of any award above the transaction price; in contrast, an award in an appraisal action is paid only to dissenting shareholders, not to the other minority shareholders.

Fairness Opinions and Valuations in Freezeout Tender Offers

A noncoercive freezeout tender offer consists of two steps: a tender offer for a majority of the minority shares and a short-form merger if the controller attains 90 percent ownership. Since the Business Judgment Rule applies to the tender offer, minority shareholders cannot receive a court review of the fairness of the price. Each shareholder has the opportunity to decide whether to tender, based on available

Continued on next page

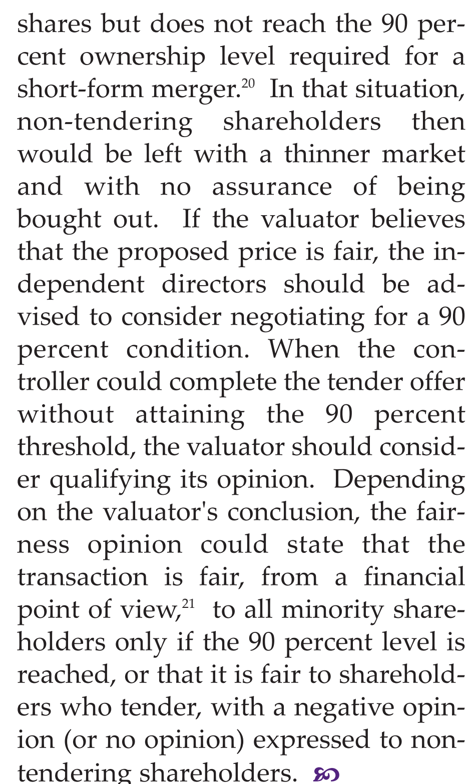
information. *Pure* provides that the independent directors should (a) be given "both free rein and adequate time to react to the tender offer, by (at the very least) hiring their own advisors," (b) make a recommendation to minority shareholders, and (c) "disclos[e] adequate information for the minority to make an informed judgment."[18] For an informed recommendation, the directors who retain a financial advisor should ask for an opinion as to the fairness of the proposed transaction, and should disclose the advisor's recommendation, and the basis for it, to the minority shareholders.

The exclusive remedy available to a minority shareholder who does not tender and objects to the price of the second-step short-form merger is appraisal. In a Delaware appraisal, a dissenting shareholder is entitled to receive a pro rata share of the equity value of the company as a going concern, with no control premium and no discount for lack of marketability or minority interest. Certain factors that would otherwise be relevant to a fairness opinion, such as synergies, increases in value attributable to the transaction itself, reduction of excessive salaries, and eliminating corporate waste, may not be included in an appraisal valuation. In addition, liquidation value may not be used as a valuation method, even if liquidation value is higher than going concern value. Recent Delaware appraisal decisions have favored discounted cash flow, but they have often also used guideline companies and guideline acquisitions, with adjustments to eliminate impermissible premiums and discounts.[19]

Independent directors who fulfill their obligations as fiduciaries by hiring their own advisor should ask their financial advisor for guidance as to the amount that minority shareholders might receive if they request appraisal. Since the appraisal remedy is available, the value that a dissenting shareholder would receive in an appraisal represents a floor below which a proposed freezeout price is not fair. The valuator should use appropriate valuation methods to determine the amount that a Delaware court might reasonably award to a dissenting shareholder in an appraisal and discuss the valuation with the independent directors. This valuation will be helpful to the independent directors in discussions with the controller. Disclosure of the financial advisor's valuation conclusions, and a description of inputs and methods used (with customary caveats), should be helpful to shareholders in deciding whether to tender or to seek appraisal.

Fairness Opinions When Tender Offer Might Not Achieve 90 Percent Ownership

An issue not addressed in the recent Delaware decisions is the impact of a proposed freezeout tender offer on minority shareholders if the controller purchases a majority of the minority



shares but does not reach the 90 percent ownership level required for a short-form merger.[20] In that situation, non-tendering shareholders then would be left with a thinner market and with no assurance of being bought out. If the valuator believes that the proposed price is fair, the independent directors should be advised to consider negotiating for a 90 percent condition. When the controller could complete the tender offer without attaining the 90 percent threshold, the valuator should consider qualifying its opinion. Depending on the valuator's conclusion, the fairness opinion could state that the transaction is fair, from a financial point of view,[21] to all minority shareholders only if the 90 percent level is reached, or that it is fair to shareholders who tender, with a negative opinion (or no opinion) expressed to non-tendering shareholders. ✪

---

1 "A freezeout is a transaction in which a controlling shareholder buys out the minority shareholders in a publicly traded corporation, for cash or the controller's stock. Freezeouts are also known, with some occasional loss of precision, as 'going private mergers,' 'squeezeouts,' 'parent-subsidiary mergers,' 'minority buyouts,' 'take outs,' or 'cash-out mergers.'" Guhan Subramanian, "Fixing Freezeouts," *115 Yale L.J. 2* (2005), p. 5. Our article does not address third-party going-private transactions.

2 See William T. Allen, Jack B. Jacobs, and Leo E. Strine, Jr., "Function Over Form: A Reassessment of Standards of Review In Delaware Corporation Law," *Del. J. Corp. Law 859.*

3 *Weinberger v. UOP,* 457 A.2d 701 (Del. 1983) at 711.

4 *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001). In the literature, this case is described either as *Glassman* or as *Unocal Exploration* (as in this article).

5 *In re Siliconix Incorporated Shareholder Litigation,* 2001 Del. Ch. LEXIS 83, 2001 WL 716787 (Del. Ch., June 19, 2001).

6 Faith Stevelman Kahn, "Freezeout Doctrine: Going Private at the Intersection of the Market and the Law," *Business Lawyer* (forthcoming), pp. 24-5. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952331

7 *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994).

8 F.S. Kahn, p. 24.

9 Peter V. Letsou & Steven M. Haas, "The Dilemma That Never Should Have Been: Minority Freeze Outs in Delaware," *Business Lawyer,* Nov. 2005, p. 26.

10 F.S. Kahn, p. 23.

11 DEL. CODE ANN. tit. 8 §253.

12 *Unocal Exploration* at 247.

13 *Id.* at 248.

14 *In re Pure Resources, Inc. Shareholder Litigation,* 808 A.2d 421 (Del. Ch. 2002) at 445.

15 *In re Cox Communications, Inc. Shareholder Litigation,* 879 A.2d 604 (Del. Ch. 2005) at 607.

16 *Pure* at 445.

17 *Weinberger* at 711.

18 *Pure* at 445.

19 For a discussion of Delaware appraisals, see Gilbert E. Matthews, "A Review of Valuations in Delaware Appraisal Cases, 2004-2005," *Business Valuation Review,* June 2006.

20 If the controller owns less than 80 percent, it could purchase a majority of the minority without reaching 90 percent.

21 "Fairness, from a financial point of view," the customary language in fairness opinions, may equal or exceed the applicable legal standard for fairness.