Financial Advisory Services Insights

The Role of Independent Financial Advisers in Minority Squeeze-Out Mergers after *Unocal Exploration Corp.* and *Siliconix Incorporated*

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Introduction

Two recent Delaware court cases addressed the issue of fairness in (1) mergers between a parent company and a subsidiary at least 90 percent owned by the parent company and (2) tender offers by controlling shareholders for minority-held shares in a controlled corporation.

In these cases, the courts ruled that controlling shareholders are not required to prove that the offers meet the strict legal definitions of fairness. In addition, the two Delaware court decisions also indicate that a target company's board of directors can remain neutral on the tender offers. In both instances, the objecting minority shareholders invoked their appraisal rights under Delaware law.

After the collapse of Enron, there is (1) an increased scrutiny on management's fiduciary duty and (2) a heightened awareness of the issues surrounding all types of corporate transactions. The post-Enron atmosphere has caused many target company boards of directors to respond to minority squeeze-out offers by creating a special committee of the board to study the proposed merger. That special committee typically retains a financial adviser to consider whether the offer is fair to the minority shareholders.

This article presents (1) an overview of *Glassman* v. *Unocal Exploration Corp.* and *In re Siliconix Incorporated Shareholders Litigation*, (2) a summary of minority squeeze-outs after these two court decisions, and (3) a discussion of the factors to consider when selecting a financial adviser to issue a fairness opinion.

Glassman v. *Unocal Exploration Corp.*

In *Glassman* v. *Unocal Exploration Corp.,* No. 390, 2000 Del. Sup. Ct. (July 25, 2001), the Supreme Court of Delaware held that the only remedy in connection with the short-form merger was shareholder appraisal rights. The Court stated: "The parent corporation does not have to establish entire fairness, and, absent fraud or illegality, the only recourse for a minority stockholder who is dissatisfied with the merger consideration is appraisal."

This decision addressed the issue of "entire fairness" regarding a short-form merger. A short-form merger is a merger between a parent company and a subsidiary at least 90 percent owned by the parent company.

The Facts of the Case

Unocal Corporation ("Unocal") is one of the largest U.S.-based independent oil and gas exploration and production companies. At the time of the merger considered in this case, Unocal owned 96 percent of the stock of its subsidiary, Unocal Exploration Corporation (UEC), an oil and gas company operating in the Gulf of Mexico. Unocal management believed that by eliminating UEC, it would benefit from reduced income taxes and overhead expenses.

Both the board of Unocal and the board of UEC appointed special committees. Both boards ultimately agreed to a merger exchange ratio of 0.54 shares of Unocal stock for each share of UEC. The UEC minority shareholders were then informed of the notice of merger.

On behalf of the minority shareholders, the plaintiffs in the case asserted that Unocal and its directors breached their fiduciary duties of (1) entire fairness and (2) full disclosure.

The Trial Court Decision

At trial, the Delaware Court of Chancery determined that:

1. the prospectus did not contain any material misstatements or omissions,
2. the entire fairness standard does not control in a short-form merger, and
3. plaintiffs' exclusive remedy in this case was shareholder appraisal rights.

The Delaware Supreme Court affirmed the decision of the Court of Chancery.

Delaware Supreme Court Analysis

As part of its decision, the Delaware Supreme Court summarized the landmark cases related to §253 and §251 of the Delaware General Corporation Law. These sections cover short-form mergers (§253) and long-form mergers (§251). A short-form merger is a merger between a parent company and a subsidiary at least 90 percent owned by the parent company.

The first review of §253 by the Delaware Supreme Court was in 1959 in *Coyne* v. *Park & Tillford Distillers Corporation,* 154 A.2d 893 (Del. 1959). In that case, the Court held that §253 plainly did permit (1) the payment of cash for whole shares surrendered in a merger and (2) the consequent expulsion of a stockholder from the enterprise in which he has invested. The *Coyne* court ruled that the §253 statute was constitutional.

In *Stauffer* v. *Standard Brands Incorporated,* 187 A.2d 78 (Del. 1962), the Court was asked to award equitable relief to minority stockholders who objected to a short-form merger. The Supreme Court (1) affirmed the Court of Chancery decision that appraisal rights were the stockholder's exclusive remedy and (2) dismissed the complaint.

In *Stauffer*, the Delaware Supreme Court explained:

> The dispute reduces to nothing but a difference of opinion as to value. Indeed it is difficult to imagine a case under the short merger statute in which there could be such actual fraud as would entitle a minority to set aside the merger. This is so because the very purpose of the statute is to provide the parent corporation with a means of eliminating the minority shareholder's interest in the enterprise. Thereafter the former stockholder has only a monetary claim.

In 1971, the Court of Chancery applied *Stauffer* to a §251 long-form merger in *David J. Greene & Co.* v. *Schenley Industries, Inc.*, 281 A.2d 30 (Del. Ch. 1971) The Court concluded in *Schenley* (1) that fair value was the plaintiff's only real concern and (2) that appraisal was an adequate remedy.

The Chancery Court explained:

> While a court of equity should stand ready to prevent corporate fraud and any overreaching by fiduciaries of the rights of stockholders, by the same token this Court should not impede the consummation of an orderly merger under the Delaware statutes, an efficient and fair method having been furnished which permits a judicially protected withdrawal from a merger by a disgruntled stockholder.

The Supreme Court took a step back from *Stauffer* in 1977 in the case of *Singer* v. *Magnavox Co.,* 380 A.2d 969 (Del. 1977). Unlike *Stauffer*, this case was also a §251 long-form merger. The Supreme Court determined that a controlling shareholder breached its fiduciary duty in a merger if the sole business purpose is to eliminate the minority stockholders.

This business purpose test was again affirmed by the Supreme Court in 1979 for a §253 short-form merger in *Roland International* v. *Najjar*. The *Roland* court wrote:

> The short form permitted by §253 does simplify the steps necessary to effect a merger . . . but we find nothing magic about a 90% ownership of outstanding shares which would eliminate the fiduciary duty owed by the majority to the minority . . . as we observed in Singer, we did "not read the decision [Stauffer] as approving a merger accomplished solely to freeze-out the minority without a valid business purpose."

The Supreme Court modified its opinion in 1983, in *Weinberger* v. *UOP, Inc.,* 457 A.2d 701 (Del. 1983). This case removed the business purpose test to "return to the well established principles of *Stauffer* . . . and *Schenley* . . . mandating a stockholder's recourse to the basic remedy of appraisal."

In 1985, however, the Supreme Court did away with the notion that appraisal was intended to be the exclusive remedy in non-fraudulent mergers apparent in the *Weinberger* decision. In *Rabkin* v. *Philip A. Hunt Chemical Corp.*, 498 A.2d 1099 (Del. 1985), the Supreme Court (through its interpretation of *Weinberger*), effectively eliminated appraisal as the exclusive remedy for any claim alleging breach of the duty of entire fairness. *Rabkin* was also a §251 long-form merger, and there was no discussion of the impact on short-form mergers.

Two additional decisions touched on the subject of entire fairness (1) in *Bershad* v. *Curtiss-Wright Corp.,* 535 A.2d 840 (Del. 1987) and (2) in *Kahn* v. *Lynch Communication Systems, Inc.,* 638 A.2d 1110 (Del. 1994). In *Lynch*, the Court described entire fairness as the exclusive standard of review in a cash-out, parent/subsidiary merger.

The Supreme Court Decision

The Delaware Supreme Court considered the history of cases on entire fairness as well as the distinction between short-form and long-form mergers. The Court noted the difficulty in reconciling the inherent fiduciary duty of the parent company with the authorized procedure allowed under the short-form merger statute §253.

A short-form merger is a unilateral decision by the parent company. The minority shareholders do not approve the merger, and there is no vote. As a result, if the parent company follows the statute, it will fall short of the entire fairness fiduciary requirement. However, if the parent company sets up committees and hires experts under its fiduciary duty, then it has lost the benefit provided under the statute.

The Supreme Court concluded, "in order to serve its purpose, §253 must be construed to obviate the requirement to establish entire fairness." As a result, the Court's decision was "that absent fraud or illegality, appraisal is the exclusive remedy available to a minority stockholder who objects to a short-form merger."

While the decision does not require the parent company to comply with entire fairness in a short-form merger, the duty of full disclosure remains. The minority stockholder must be provided with necessary factual information available in order to accept the merger consideration or seek appraisal. Therefore, the Supreme Court affirmed the decision of the Court of Chancery and held that plaintiffs' only remedy in connection with the short-form merger of UEC into Unocal was appraisal rights.

In Re Siliconix Incorporated Shareholders Litigation

In re Siliconix Incorporated Shareholders Litigation, C.A. No. 18700 Del. Ch. (June 19, 2001), plaintiff Raymond L. Fitzgerald ("Fitzgerald"), a shareholder in defendant Siliconix Incorporated ("Siliconix"), brought this action to challenge the stock-for-stock tender offer by defendant Vishay Intertechnology, Inc. ("Vishay"). The tender offer was made by Vishay through its wholly-owned subsidiary, Vishay TEMIC Semiconductor Acquisition Holdings Corp. ("Acquisition"). The tender offer was for the 19.6 percent equity interest in Siliconix that Acquisition did not already own. Fitzgerald moved to enjoin the tender because of alleged breaches by Vishay and the directors of Siliconix of their fiduciary duties to Siliconix shareholders.

This decision addressed the issue of fairness regarding a tender offer by a controlling shareholder extending an offer for minority-held shares in the controlled corporation.

Factual History

Vishay, a manufacturer of passive electronic components and semiconductor components, owned 80.4 percent of the equity in Siliconix. Vishay was listed on the New York Stock Exchange. Siliconix designs, markets, and manufactures power and analog semiconductor products. Siliconix was listed on the Nasdaq.

Vishay acquired its 80.4 percent interest in Siliconix in March 1998. Since then, the stock price of Siliconix fluctuated dramatically, from a high of $165 in March 2000, to a low of under $17 in December 2000. Despite reporting increased profits, (1) the recent economic downturn and (2) its reliance on the cellular phone industry adversely affected Siliconix.

In early 2001, Vishay considered repurchasing the remaining Siliconix shares that it did not own. On February 22, 2001, Vishay announced a proposed all-cash tender offer for the publicly held Siliconix common stock at a price of $28.82 per share. Vishay also announced that if it obtained over 90 percent of the Siliconix stock, it would consider a short-form merger of Siliconix into Vishay for the same price. The offer price was determined simply by applying a 10 percent premium to the market price of Siliconix stock. No effort was made by Vishay to value Siliconix.

After the February 22, 2001, press release, the Siliconix board designated a special committee consisting of two directors. The special committee engaged a financial adviser and legal counsel. On May 2, 2001, Vishay management met with the special committee and was told that the offer was not adequate.

On May 23, 2001, Vishay informed the special committee that it was considering proceeding with a stock-for-stock exchange offer without first obtaining the special committee's approval. On May 25, 2001, Vishay announced an exchange offer under which it would exchange 1.5 shares of Vishay common stock for every share of Siliconix common stock. The proposed share exchange was simply the ratio of the Siliconix and Vishay stock prices as of the proposal date, and it carried no market premium.

Vishay's offer contained a nonwaivable "majority of the minority" provision providing that Vishay would not proceed with its tender offer unless a majority of the shareholders not affiliated with Vishay tendered their shares. Vishay also stated that it intended to effect a short-form merger following a successful tender offer. However, it noted that it was not required to do so. In a short-form merger, (1) the minority shareholders would receive the same per share consideration as in the exchange offer and (2) the objecting shareholders could invoke their appraisal rights under Delaware law.

On June 8, 2001, Siliconix filed a Schedule 14D-9 setting forth its disclosures concerning the Vishay offer. Siliconix reported that the special committee elected to remain neutral and made no recommendation with respect to the tender offer. The financial adviser was never asked to prepare a fairness opinion regarding the exchange offer.

Fitzgerald claimed that the offer was unfair. In support of that argument, Fitzgerald submitted the report of an expert who concluded that the Vishay offer was "materially lower than the fair value of Siliconix."

The Analysis by the Delaware Court of Chancery

According to the Chancery Court's decision, in responding to a voluntary tender offer, shareholders of Delaware corporations are free to accept or reject the tender based on their own evaluation of their best interests. That choice will normally depend upon each stockholder's individual investment objectives and his/her evaluation of the merits of the offer.

The Chancery Court ruled that "as a general principle, our law holds that a controlling shareholder extending an offer for minority-held shares in the controlled corporation is under no obligation, absent evidence that material information about the offer has been withheld or misrepresented or that the offer is coercive in some significant way, to offer any particular price for the minority-held stock."

The Court concluded that (1) since the tender offer was not coercive and (2) since there were no disclosure violations, then Vishay was not obligated to offer a fair price in its tender.

Fitzgerald also claimed that the Siliconix board breached its duty of care by (1) not carefully evaluating the proposed transaction and then (2) not developing—with appropriate assistance from a financial adviser—a recommendation to stockholders regarding the tender offer.

The Court ruled against Fitzgerald since (1) there was adequate disclosure as Vishay disclosed accurately all material facts surrounding the tender and (2) no coercion existed as the target minority shareholders could accept or reject the offer.

According to the Court:

> It may seem strange that scrutiny given to tender offer transactions is less than the scrutiny that may be

> given to, for example, a merger transaction which is accompanied by more general breaches of fiduciary duty by the directors of the acquired corporation. . . . The difference in judicial approach can be traced to two simple concepts. The first is that accepting or rejecting a tender is a decision to be made by the individual shareholder, and at least as to the tender itself, he will, if he rejects the tender, still own the stock of the target company following the tender. The second concept is that the acquired company in a merger context enters into a merger agreement, but the target company in the tender context does not confront a comparable corporate decision because the actual target of a tender is not the corporation (or its directors), but, instead, is its shareholders. Indeed, the board of the tender target is not asking its shareholders to approve any corporate action by the tender target.

Fitzgerald claimed that the board of Siliconix was required (1) to take a position on whether the Siliconix shareholders should accept the tender and (2) to inform the shareholders of that decision and the reasons for it based on *McMullin* v. *Beran*. The Court ruled that the major difference between this case and the *McMullin* case was that *McMullin* involved a merger of the subsidiary into a third-party, which was a transaction that the subsidiary board sought the approval of the minority shareholders.

Since the Siliconix minority shareholders had the power to reject the tender offer (since it would only go forward if a majority of the minority owned shares were tendered), the Court ruled that the *McMullin* case cannot be read to require application of the entire fairness test to evaluate the proposed transaction. The Siliconix shareholder had the choice to (1) take the consideration offered or (2) seek appraisal rights if the tender offer is successful.

Based on these reasons, the Court issued an order denying Fitzgerald's motion for a preliminary injunction on June 19, 2001.

Minority Squeeze-Out Mergers after *Unocal* and *Siliconix*

There have been a number of minority squeeze-out mergers subsequent to the 2001 landmark court cases summarized above. The *Unocal* and *Siliconix* cases indicate that the target company's board of directors can remain neutral on offers from a corporate parent that controls the target company.

However, after the collapse of Enron and the increased public attention on fiduciary duty, many target company boards of directors have responded to minority squeeze-out offers by setting up a special committee of the board. Those committees often retain a financial adviser to consider whether the offer is fair to the minority shareholders.

The following presents a brief summary of some of these transactions. In these examples, hiring of the financial adviser resulted in a higher price being paid to the minority shareholders.

SBC Communications Inc. Tender Offer for Prodigy Communications Corporation

On September 21, 2001, SBC Communications Inc. (SBC) announced a tender offer for the remaining outstanding common shares of Prodigy Communication Corporation ("Prodigy") that it did not already own. The offer price of $5.45 per share was a 54 percent premium over the most recent closing price.

In a press release dated October 15, 2001, SBC announced that it was negotiating with a special committee of the board of directors of Prodigy regarding a possible increase in the offer price. It was indicated that SBC was in "discussions about a negotiated transaction with the special committee, which has informally suggested a tender price of $6.55. SBC has indicated the possibility of increasing the offer price to the $6.00 to $6.25 range."

On October 18, 2001, SBC reported an agreement to revise its tender offer to $6.60 per share, a 21 percent increase over the original offer. The estimated transaction value increased from $407 million to $496 million.

The successful completed tender offer was reported on November 2, 2001, with SBC owning approximately 90.6 percent of Prodigy's outstanding shares. With ownership over 90 percent of the shares outstanding, SBC was then able to complete a short-form merger.

Toronto-Dominion Bank Tender Offer for TD Waterhouse Group, Inc.

On October 10, 2001, Toronto-Dominion Bank ("TD Bank") announced a tender offer for all of the approximately 12 percent of TD Waterhouse Holdings, Inc. ("TDW") that it did not already own. The offer of $9.00 per share represented a 45 percent premium over the prior day's closing price. The offer was conditioned upon TD Bank owning at least 90 percent of the common stock after the tender offer. Those shares not acquired in the tender offer were expected to be acquired in a short-form merger at the same price.

On October 30, 2001, TD Bank announced an increase in the tender offer price to $9.50 per share, a 5.6 percent increase over the original offer. According to the press release, "the increase follows discussions between TD Bank and the special committee of independent TD Waterhouse directors." This final offer also required that a majority of the publicly held shares be tendered. As a result of the negotiations, the estimated transaction value increased by approximately $20 million.

The press release indicated that TDW's special committee determined the tender offer was fair and that "the special com-

mittee has also received the opinion of its independent financial adviser as to the fairness of the offer from a financial point of view to TD Waterhouse's stockholders other than TD Bank and its affiliates." Based on this opinion, TDW recommended that the stockholders accept the amended offer.

Sabre Holdings Corporation Tender Offer for Travelocity.com

On February 19, 2002, Sabre Holdings Corporation ("Sabre") announced its intention to make a tender offer for the common shares of Travelocity.com ("Travelocity") that it did not already own. At the time of the announcement, Sabre held approximately 70 percent of Travelocity. Sabre intended to offer $23.00 per share conditioned on the tender raising the ownership interest in Travelocity to over 90 percent.

The offer price represented a 19.8 percent premium over the most recent closing price. A short-form merger would follow at the same price as the tender offer.

Sabre announced the $23.00 per share offer on March 5, 2002. Sabre increased the price of its offer to $28.00 per share on March 18, 2002. Travelocity's shareholders were informed that "a special committee of outside, independent directors of Travelocity's Board of Directors has determined that the amended offer price is adequate."

On April 8, 2002, Sabre announced the successful completion of the tender offer at $28.00 per share, representing a 21.7 percent increase over the original offer. As a result, the estimated transaction value increased from $403 million to $491 million.

Factors to Consider when Selecting a Financial Adviser to Issue a Fairness Opinion

Factors for directors to consider when evaluating financial advisers to render a fairness opinion include (1) avoiding financial advisers with a conflict of interest and (2) avoiding entering into contingent fee arrangements. Both of these factors would impair the independence of the financial advisers.

An important consideration in determining which financial adviser is suitable to issue a fairness opinion is the objectivity of the adviser. The credibility of a fairness opinion depends, to a large degree, on whether it is prepared by an adviser who can be viewed by the shareholders and by the courts as unequivocally independent.

Investment bankers have historically been retained to issue a majority of fairness opinions. Recently, there has been an increasing focus on the potential for a conflict of interest when retaining an investment banker to prepare a fairness opinion.

Investment banks may face strong incentives to provide opinions that serve the interests of management in instances where the bank has a relationship with management and has played a part in structuring the transaction. An example of the concern regarding the perception of a conflict of interest is the proposed mid-1996 purchase of 50 percent of Michigan Healthcare by Columbia/HCA Healthcare Corp. for $43.8 million. The fairness opinion prepared by Dean Witter Reynolds as part of the transaction was challenged by the Michigan Attorney General. This was because Dean Witter had served as an underwriter in public offerings of Columbia securities and had advised Columbia in other transactions.

Additionally, since compensation paid to investment bankers for structuring a deal is generally dependent on the completion of the transaction, the issuance of a fairness opinion by the investment banking firm is clearly a conflict of interest. This is because contingent fees create incentives for advisers to help execute transactions.

For example, *In re Siliconix Incorporated Shareholders Litigation*, the investment banking firm's proposed compensation consisted of a $50,000 retainer, $250,000 for a fairness opinion, and a transaction fee of $1.75 million to be paid upon the closing of the transaction. The plaintiff in that matter argued that the compensation arrangement provided an incentive for the financial adviser to approve the transaction.

Summary and Conclusion

This article summarized two recent Delaware court cases that addressed the issue of fairness in minority squeeze-out mergers. In these cases, the two Delaware courts ruled (1) that controlling shareholders are not required to prove that offers meet strict legal definitions of fairness and (2) the target company's board of directors can remain neutral on the offers.

The article also presented examples of minority squeeze-out mergers occurring after these court decisions. The post-Enron atmosphere has caused many target company boards of directors to respond to minority squeeze-out offers by setting up a special committee of the board. That special committee typically retains a financial adviser to consider whether the offer is fair to the minority shareholders. In these examples, the hiring of a financial adviser resulted in a higher price being paid to minority shareholders.

Directors of both publicly traded and closely held companies are increasingly retaining independent financial advisers to render fairness opinions for transactions. This is due to the increased scrutiny regarding the conflicts of interest of investment bankers involved in some transactions. As an independent financial advisory firm, Willamette Management Associates has significant experience in issuing fairness opinions (1) in minority squeeze-out mergers and (2) in a variety of other types of transactions.

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