A NEW ROADMAP FOR GOING-PRIVATE TRANSACTIONS

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INTRODUCTION

For many years, Delaware courts have required a controlling stockholder seeking to acquire the minority interests in one of its subsidiaries to make a difficult choice. The controlling stockholder could use its majority ownership position to approve and complete the buyout, in which case it would have the burden of proving, in the event of litigation, that both the buyout price and the buyout process were fair to the minority stockholders (usually referred to as the "entire fairness" doctrine). Alternatively, the controlling stockholder could shift the burden of proving fairness to the plaintiff by following a process designed to replicate arms'-length negotiations with its subsidiary – usually either by negotiating with a special committee of independent subsidiary directors or, less commonly, by conditioning its buyout offer on acceptance by a majority of the minority stockholders. In these situations, which party bears the burden of proof is often outcome determinative.

Because of the substantial disadvantage of having to satisfy a burden of proof in litigation, most going-private buyouts subject to the entire fairness doctrine have been structured to shift the burden of proof to the plaintiff. Most typically, the transactions are negotiated with a special committee of independent subsidiary directors and are subject to the committee's prior approval. This approach, while common, often results in protracted and occasionally stalemated negotiations as the special committee and its independent legal and financial advisors endeavor to create a record of arms'-length bargaining. In addition, the process creates its own litigation risks, with stockholder lawsuits focusing on the integrity and effectiveness of the special committee's deliberations and actions. A less common alternative approach – conditioning the offer on acceptance by a majority of the minority stockholders – enables the controlling stockholder to choose the price and other terms and set the timing of the transaction. The downside of this approach is that it puts the success of the transaction at greater risk, particularly if the minority shares are concentrated in the hands of a few institutional investors who can block approval of the transaction.

Recently, however, a pair of Delaware cases have mapped out an approach to subsidiary buyout transactions that allows the controlling stockholder to unilaterally set the price and other transaction terms and control the timing of the transaction without having to prove the fairness of the transaction. While admittedly some ambiguity persists as to the role of a target board (or special committee) in guiding minority stockholders, an examination of the subsidiary

buyouts that have been announced or completed following the decisions evidences greater confidence on the part of bidders to bring timing discipline to a buyout process that had been relatively time-consuming and unpredictable. The decisions even provide a legal basis for a bidder to avoid any price negotiations with a target board (or special committee), although perception issues and other practical concerns may militate against this approach.

DELAWARE SUPREME COURT HOLDS APPRAISAL IS EXCLUSIVE REMEDY IN SHORT-FORM MERGER

FACTUAL BACKGROUND

Unocal Corporation, which owned 96% of Unocal Exploration Corporation, sought to acquire the public's minority interest through a short-form merger. In part because of uncertainty as to whether short-form mergers were subject to the entire fairness standard, Unocal caused Unocal Exploration to form a special committee to negotiate the merger price on behalf of the minority stockholders.

The special committee hired independent financial and legal advisors and proceeded to negotiate the exchange ratio with Unocal. After discussions with the special committee, Unocal increased the initially proposed exchange ratio and the special committee's financial advisor issued a formal fairness opinion.

On the day the merger was announced, the plaintiffs sued, claiming that the directors breached their fiduciary duty of entire fairness, citing concerns with both the "fair price" and "fair dealing" prongs of the entire fairness standard.

OPINION OF DELAWARE SUPREME COURT

In Glassman v. Unocal Exploration Corp., 777 A.2d 242 (Del. July 25, 2001), the Delaware Supreme Court held that in a short-form merger the parent corporation did not have to establish entire fairness and that the appointment of a special committee was legally unnecessary. The Court reasoned that the Delaware legislature effectively circumscribed the parent company's obligations to the minority in a short-form merger by authorizing the elimination of the minority without notice, board vote, stockholder vote or any other indicia of procedural fairness. Accordingly, absent fraud or illegality, appraisal was the only recourse for minority stockholders who were dissatisfied with the consideration in a short-form merger.

DELAWARE CHANCERY COURT HOLDS ENTIRE FAIRNESS REVIEW NOT APPLICABLE IN TENDER OFFER

FACTUAL BACKGROUND

On February 22, 2001, Vishay Intertechnology announced an all-cash tender offer for the remaining 19.6% equity interest in Siliconix that it did not already own. Vishay also announced that if the tender offer resulted in Vishay owning over 90% of the Siliconix stock, then it would consider effecting a short-form merger at the same price.

In response to the tender offer, and at the request of Vishay, Siliconix formed a special committee of non-management Siliconix directors to discuss the offer with Vishay. Following its formation, the special committee engaged independent financial and legal advisors. The special committee met regularly with its advisors in an effort, according to Vishay, to evaluate the tender offer proposal and negotiate the best terms, including the price, that it could obtain for Siliconix's minority stockholders.

After negotiations with the special committee proved unsuccessful, Vishay announced an exchange offer pursuant to which it would exchange 1.5 shares of Vishay common stock for each share of Siliconix common stock. Additionally, Vishay's new offer contained a non-waivable majority of the minority condition whereby Vishay would not complete the tender offer unless a majority of Siliconix's unaffiliated stockholders tendered their shares. Vishay also restated its intention to effect a short-form merger following the successful completion of the exchange offer at the same per share consideration.

The special committee advised Vishay that it was unlikely to recommend the 1.5 exchange ratio as fair to Siliconix's unaffiliated stockholders. Siliconix's Solicitation/Recommendation Statement on Schedule 14D-9 discloses that the special committee spoke with a Vishay representative on May 31, 2001 and "urged that Vishay improve the Offer … by, for example, increasing the exchange ratio, providing an adjustment to the exchange ratio or other protection in the event the market price of Vishay [c]ommon [s]tock declined, or both." Vishay declined the invitation to take any of these actions, and on June 8, 2001 Siliconix filed its Schedule 14D-9 reporting the following:

> The Special Committee … decided it would remain neutral and not make any recommendation regarding the Offer or Merger. In light of that decision by the Special Committee and the conflicts of interest described elsewhere in [the Schedule 14D-9], the Board of Directors of Siliconix also decided to remain neutral and not make any recommendation on the Offer or Merger.

The plaintiff sought to enjoin the tender offer claiming that the tender must be judged under the entire fairness standard, and that Vishay[1] could not satisfy that standard both because the tender offer price was unfair and because of the alleged disclosure violations and coercive nature of the offer.

OPINION OF DELAWARE COURT OF CHANCERY

In In Re Siliconix., CA No. 18700 (Del. Ch. June 19, 2001), the Delaware Chancery Court concluded that a controlling stockholder making a tender offer for minority-held shares in the controlled corporation has no duty to demonstrate the entire fairness of the transaction, unless coercion or disclosure violations occur. Vice Chancellor Nobel began his analysis by citing In Re Ocean Drilling & Exploration Co., C.A. No. 11898 (Del Ch. Apr. 30, 1991), for the proposition that "as a general principle, [Delaware] 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 then found that Vishay had no duty to demonstrate the entire fairness of the proposed tender offer. In so doing, the Court noted the apparent inconsistency between applying the entire fairness standard to the approval of a merger agreement and mere business judgment to a unilateral tender offer followed by a short-form merger. The Court conceded that from the minority stockholders' perspective, the distinction in the two transaction structures may seem of no real practical consequence. The Court articulated the rationale for the difference in judicial approach based on "two simple concepts". First, accepting or rejecting a tender is an individual decision, and by rejecting the tender the stockholder can continue to own, at least prior to any short-form merger, the stock following the tender. Second, the Court pointed out that the target company in a tender offer does not confront a corporate decision comparable to that faced by a target company entering into a merger agreement because the actual target of a tender offer is the stockholders rather than the corporation or its directors. The board of a tender target is not asking its stockholders to approve any corporate action. The Court contrasted this situation with a long-form merger transaction, a transaction in which Delaware corporate law requires the target board of directors to evaluate and submit the merger agreement to stockholders for their approval.

This distinction between a board's obligations in a merger and a tender offer formed a critical basis for the Court's rejection of the plaintiff's argument that McMullin v. Beran, 765 A.2d. 910 (Del. 2000), prohibited the Siliconix board from remaining neutral in response to the tender offer. In McMullin, Atlantic Richfield Company owned 80.1% of the outstanding shares

[1] In fact, the plaintiff's complaint named as defendants Siliconix, Siliconix's board, Vishay and Vishay's controlling stockholder. For the sake of convenience, however, this memorandum refers simply to Vishay when discussing the defendant class.

of ARCO Chemical Company and was primarily responsible for negotiating a merger transaction between ARCO Chemical and Lyondell Petrochemical Company. The plaintiff stockholder contended, among other claims, that the ARCO Chemical board breached its fiduciary duties to manage the sale of ARCO Chemical because it failed to assist the minority stockholders by ascertaining ARCO Chemical's value as a going concern so that the stockholders might be better able to assess the acquiring party's offer and, thus, to assist in determining whether to pursue appraisal rights. In holding for the plaintiff, the Delaware Supreme Court stated that "the board cannot abdicate [its] duty by leaving it to the shareholders alone to approve or disprove [sic] the merger agreement because the majority shareholder's voting power makes the outcome a preordained conclusion." The plaintiff in Siliconix argued that, apart from the application of the entire fairness standard, McMullin required the Siliconix board to take a position as to whether the Siliconix stockholders should accept the tender and to inform the stockholders of that decision and the reasons for it.

The Chancery Court in Siliconix read McMullin as limited to defining or confirming standards governing mergers.[2] While the Court forthrightly acknowledged that a minority stockholder seemingly faces the same decision in both a tender offer and a merger (take the consideration offered or seek appraisal), the Court noted that the Supreme Court said that fiduciary duties are "context specific" and the context in McMullin was a merger. Moreover, the Court highlighted the critical difference in the relative position of the minority: the fate of the minority is a foregone conclusion in McMullin once the merger agreement goes to a vote. The minority stockholders in McMullin therefore were powerless to prevent the merger proposed by the Chemical directors, as Atlantic Richfield controlled the vote, but in Siliconix the minority stockholders "have the power to thwart the tender offer" by not tendering their shares. This was clearly the case in Siliconix because the bidder subjected the tender offer to a majority of the minority condition (which ultimately caused the bid to fail).

The Court's decision regarding the inapplicability of McMullin in the tender offer context was hedged, however, because the Court went on to state that "[t]o the extent that McMullin may be read to require the subsidiary board to guide the minority shareholders in their decision to accept or reject a tender, I note that there may exist circumstances where there is no answer to the question of whether to accept or reject." By indicating that McMullin may require a board (or special committee) to inform the minority concerning the merits of a tender offer, this statement leaves open the possibility that the board of a subsidiary that is the subject of a tender offer by a controlling stockholder has a duty, to the extent practicable, to take a position after fully informing itself. The Siliconix Court clearly contemplated, however, that a

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[2] See Paramount Communications, Inc. v. Time Incorporated, 571 A.2d 1140 (Del. 1990) ("In the specific context of a proposed merger of domestic corporations, a director has a duty … to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders. Certainly in the merger context, a director may not abdicate that duty by leaving to the shareholders alone the decision to approve or disapprove the agreement.") (emphasis added).

board could properly remain neutral after informing itself with respect to the merits of a tender offer. The obligation of a subsidiary board to inform itself would generally encourage the retention of independent financial and legal advisors (unless all of the directors of the subsidiary board are conflicted and the board simply decides that it is unable to take a position).

IMPLICATIONS AND RECENT EXPERIENCE

Course charted. Siliconix and Unocal Exploration demonstrate how a controlling stockholder can effect a buyout of the minority holders without having to satisfy the heightened judicial scrutiny mandated by the entire fairness standard of review. In this context, a controlling stockholder has no obligation to offer a fair price or provide a fair process, provided that it satisfies its still-present disclosure obligations to the minority stockholders and the offer is not coercive. An offer could be coercive, for example, by offering higher consideration in the tender offer than pursuant to the second step short-form merger. Of course, to avoid the requirement for a target board to approve a long-form merger agreement, a controlling stockholder still needs to reach the 90% ownership threshold. Accordingly, the tender price offered must still be calculated to result in the requisite number of shares being tendered. Moreover, to the extent the subsidiary buyout is for cash, the bid will be subject to the SEC's disclosure-intensive 13e-3 going-private rules. The going-private rules require a bidder to disclose, among other matters, the reasons that it believes that the price is fair and the process was fair. In particular, the SEC has interpreted Item 8 of Schedule 13E-3 to require the filing parties to discuss in detail why they believe a transaction is procedurally fair if it is not conditioned on both special committee and majority of the minority approval. (See Release No. 34-17719). Of course, any short-form merger for cash will be subject to appraisal rights, although the time consuming nature of this process renders it impractical for most stockholders.

Buying up to 90%. A more subtle implication of these cases is that a controlling stockholder can buy shares on the open market or in privately negotiated sales in an effort to reach the 90% ownership threshold prior to effecting a short-form merger. Nothing in recent Delaware case law suggests that such a transaction would be subject to enhanced judicial scrutiny, unless the target company has a poison pill or other barrier to open-market purchases that would require target board action to waive. SEC rules would, however, still require the controlling stockholder to complete and file a Schedule 13E-3 thirty days prior to making any purchases of securities subject to the going-private transaction. The public announcement of such an intention might increase the price of the purchases to the equivalent of a tender offer price (or even higher) but still allow the bidder the opportunity to take advantage of the reduced fiduciary issues associated with a short-form merger. In addition to the Schedule 13E-3 issue, a bidder with a Schedule 13D (or Schedule 13G) on file with the SEC might also have to amend its disclosure concerning its plans and proposals regarding the target company.[3] Given

[3] The purchases would also generally give rise to a Form 4 filing obligation under Section 16.

the implications of these disclosures and the risk that the purchases could be re-characterized as a tender offer, the bidder might simply choose to commence a tender offer as a means to reach the 90% threshold.

Practical Limitations. There will likely be situations in which a controlling stockholder finds it impractical to utilize a Siliconix approach to a subsidiary buyout. For example, a controlling stockholder with a relatively low ownership interest in the subsidiary (e.g., 40%) may find it too risky to attempt to reach the necessary 90% ownership level solely through a tender offer or open-market purchases, particularly if ownership of the minority shares is concentrated in the hands of a few institutional stockholders. Moreover, the absence of a favorable recommendation of the target board (or special committee) would only render the task of reaching the 90% threshold that much more difficult. Accordingly, under such circumstances, the controlling stockholder may find it more practical to negotiate a traditional merger agreement with a special committee – which requires under Delaware law only a simple majority of all outstanding shares for approval – rather than try to reach the 90% threshold through unilateral action (particularly if not accompanied by a favorable target board recommendation). Because a merger agreement must, under Delaware law, be approved by the target's board of directors, this course of action would not be exempted from the entire fairness doctrine by the Siliconix decision. The controlling stockholder would need, therefore, to engage in traditional arms'-length negotiations with a special committee in order to agree on transaction terms. Moreover, regardless of the intentions of the controlling stockholder, a special committee is more likely to be formed when a majority of the target board is unaffiliated with the controlling stockholder.

The Siliconix approach also would not be available if the subsidiary has in place takeover defenses, such as a poison pill, that require target board action for the controlling stockholder to increase its share ownership to the 90% level.

Role of Independent Directors and Special Committee. While the Unocal Exploration case charts a clear path for acquiring the minority interests in a subsidiary pursuant to a short-form merger without entire fairness review or a special committee, the Siliconix case does not provide clear guidance as to the role of a special committee in those cases in which the controlling stockholder uses a unilateral tender offer to reach the 90% ownership threshold to consummate a short-form merger. This ambiguity remains despite Siliconix making clear that the bidder in such circumstances has no obligation to offer a fair price. The Siliconix Court did not resolve conclusively the question of whether, as a matter of business judgment, a subsidiary board must inform itself and seek to provide guidance to minority stockholders concerning the merits of a tender offer (including remaining neutral if the reasons for and against tendering balance each other out). This issue is heightened by federal tender offer rules which require a target board to take a position with respect to a pending offer (or state that it is remaining neutral or unable to take a position). The Siliconix Court did not address the implications of these federal requirements on the target board's obligation to guide minority stockholders or

any related obligation under Delaware law to inform itself in connection with satisfying federal requirements.

In the event, however, that the Supreme Court of Delaware supports the line of analysis in Siliconix that the target board (or special committee) has no obligation to guide the minority stockholders, then this would provide a firm basis under Delaware law for a subsidiary board to take no action to inform itself concerning a tender offer and, simply, leave the decision as to whether to tender to the stockholders.

Recent Experience. Recent experience suggests that, as a practical matter, a role may continue to exist for a committee of independent directors of the target even when a controlling stockholder initiates a subsidiary buyout by means of a unilateral tender offer. This was the case when The Toronto-Dominion Bank recently commenced its tender offer to purchase the 12% of its discount-brokerage subsidiary, TD Waterhouse Group, that it did not already own. Toronto-Dominion's initial offer was not subject to a majority of the minority condition, and Toronto-Dominion indicated its intention to effect a short-form merger if it reached the 90% ownership threshold. Although Toronto-Dominion unilaterally commenced its offer without asking the board of directors of TD Waterhouse to approve the offer, TD Waterhouse's board of directors (which included directors unaffiliated with Toronto-Dominion) established a special committee to consider and recommend what actions the full board should take in response to Toronto-Dominion's offer, including how TD Waterhouse should respond to the tender offer in its Schedule 14D-9. Following discussions with the special committee, Toronto-Dominion ultimately agreed to amend its offer to increase the offer price from $9.00 per share to $9.50 per share and to subject the offer to the condition that a majority of the publicly held shares be tendered. In turn, the special committee recommended the amended offer and the offer was successfully completed.

Similarly, SBC Communications unilaterally commenced an offer for Prodigy Communications, a 42% owned subsidiary, without obtaining the prior approval of the Prodigy board of directors. In contrast to Toronto-Dominion, however, SBC conditioned its initial offer on the satisfaction of a majority of the minority condition. This condition effectively gave Telmex, a significant Prodigy stockholder, the ability to block the tender offer because the majority of the minority condition could not be met unless Telmex tendered a substantial portion of its shares. As was the case in the Toronto-Dominion transaction, Prodigy's board of directors established a special committee of independent directors to consider the offer, including a response for the purposes of Schedule 14D-9. Ultimately, the special committee recommended the offer after negotiating an increase in the tender offer price from $5.45 per share to $6.60 per share. In addition, the special committee approved a long-form merger agreement between SBC and Prodigy which further assured the certainty of a 100% acquisition. The subsidiary board's approval of a long-form merger agreement could, however, potentially make the whole transaction subject to the entire fairness doctrine. This would undermine the benefits that a unilateral offer is designed to achieve.

Most recently, the Spectra-Physics special committee, after retaining independent financial and legal advisors, remained neutral in responding to a tender offer by its 80% parent, Thermo Electron. On August 21, 2001, Thermo Electron announced its intention to make a tender offer for all the outstanding shares of Spectra-Physics at $20.00 per share in cash. A special committee was formed consisting of directors unaffiliated with Thermo Electron. The special committee met and engaged independent financial and legal advisors. After the events of September 11, 2001, Thermo Electron indicated that it was revaluing its bid and ultimately announced in early November that it was reducing its bid to $17.50 per share in cash. Although the special committee received a fairness opinion with respect to the revised offer price, it ultimately remained neutral based, in part, on Thermo Electron's refusal to negotiate the offer price.

Even with the appointment of a special committee, however, the controlling stockholder is still able to control the timing and terms (including offer conditions) of the buyout process in ways that were not possible under the traditional, negotiated-transaction approach to buyouts. In particular, the special committee's timetable for acting is dictated by Rule 14e-2 under the federal tender offer rules, which requires that the special committee decide what position, if any, it wishes to take with respect to the controlling stockholder's tender offer by the tenth business day after the offer is commenced. Since the controlling stockholder can unilaterally decide when to commence the offer, it can also set the time frame for special committee action. Moreover, the controlling stockholder can, as a strict legal matter, ultimately decide to consummate the offer in the absence of a favorable recommendation. As noted, Thermo Electron proceeded with its offer despite a neutral position from the special committee, although its decision to proceed may have been made easier by the fairness opinion that accompanied the neutral position. Other bidders may, however, be concerned about the perception issues that may accompany proceeding in the absence of a favorable recommendation.

Although in each of the Toronto-Dominion, SBC and Thermo Electron bids the subsidiary board formed a special committee, one circumstance in which an independent committee should not need to be formed is when all of the target directors are affiliated with the parent. If all of the directors on the target's board are conflicted, then nothing in Delaware law suggests that a target board has an obligation to seek new directors (although certain boards have done this when approving a long-form merger agreement). In the recently announced unilateral tender offer by UtiliCorp for Aquila, its 80% owned subsidiary, Utilicorp indicated that a special committee would not be formed because all of the directors of Aquila were affiliated with Utilicorp. In that case, however, the tender offer was subject to a majority of the minority condition. Even though not legally required, this provided greater legal (and public relations) protection and may have had little downside because Utilicorp, by virtue of its 80% ownership, needed a majority of the public stockholders in order to reach the 90% short-form merger threshold.

CONCLUSION

The Siliconix and Unocal Exploration decisions have provided a basis for a controlling stockholder to effect a subsidiary buyout without entire fairness review or even the use of a special committee. To the extent that a controlling stockholder commences a tender offer to acquire 90% ownership in order to be able to effect the second-step merger, the Siliconix decision provides qualified support to a bidder that proceeds without a target board (or a special committee) guiding the minority. Nonetheless, there may be valid reasons for a bidder to facilitate (or tolerate) the formation of a special committee even though the transaction is not subject to entire fairness review. Legally, a special committee addresses the ambiguity in the Siliconix decision as to whether, even in the absence of the entire fairness standard, the subsidiary board has the obligation to guide the minority stockholders in their decision to accept or reject the tender offer. Even though not legally required, a controlling stockholder may seek the recommendation of a special committee to avoid the perception that the controlling stockholder is acting in an inequitable manner. While bidders have traditionally expressed concern about the execution risk inherent in the special committee process, that risk has been ameliorated by the combination of the discipline imposed on the process by the federal tender offer time periods and the flexibility that is now available to a controlling stockholder, under Delaware law, to effect a subsidiary buyout (by means of a tender offer and short-form merger) without a special committee's approval.

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If you have any questions concerning the Siliconix or Unocal Exploration decisions or their effect on going-private transactions, please do not hesitate to contact John Finley (212-455-2583; jfinley@stblaw.com), Lee Meyerson (212-455-3675; lmeyerson@stblaw.com), or Rob Spatt (212-455-2685; rspatt@stblaw.com).

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