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March 10, 2010

# Corporate Governance Group Client Alert

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## DELAWARE COURT CRITICIZES BOARD'S "STRONG-ARMED" TACTICS IN STAGING FREEZE-OUT MERGER

### *Sides with Minority Shareholder on Valuation of Her Shares*

In *In Re Sunbelt Beverage Corp.*,<sup>1</sup> the Delaware Court of Chancery recently applied the entire fairness standard in reviewing a freeze-out merger involving Sunbelt Beverage Corporation. The Court determined that the "sole purpose" of the merger was to forcibly cash out a minority shareholder in order to exclude her from an attractive corporate transaction that was to take place soon thereafter. The Court also sharply criticized the process employed by Sunbelt's board, and sided with the minority shareholder in valuing Sunbelt stock at 2.5 times the value payable in the merger.

#### **Background**

Sunbelt is a privately-held Delaware corporation engaged in the wholesale distribution of wine and liquors in several states. Janet Goldring first became a shareholder in 1991, when she was issued 54,000 shares of Sunbelt stock in exchange for certain alcohol distribution rights held by her in Florida. Over the next several years, as Sunbelt "posted record profits," Goldring, as well as members of the Merinoff family, increased their respective ownership stakes in Sunbelt. On March 31, 1994, the Merinoffs entered into a share purchase agreement with various shareholders (not including Goldring) that resulted in the Merrinoffs owning a majority interest in Sunbelt. This arrangement also permitted the Merinoffs to make additional purchases from these shareholders over the next three years at a price determined in accordance with an agreed-upon formula (the "Formula"). At about the same time, Goldring

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<sup>1</sup> Consol. C.A. No. 16089-CC (Delaware Court of Chancery January 5, 2010).

entered into a share purchase agreement with another shareholder to purchase an additional 60,000 shares, subject to put and call rights in the case of certain triggering events at a price based on the Formula. As a result of this transaction, Goldring's ownership stake climbed to 15%.

In the spring and summer of 1997, Herman Merinoff repeatedly contacted Goldring to discuss the possibility of purchasing all of her Sunbelt shares at the Formula price. Goldring rejected these offers, arguing that they "extremely undervalued" Sunbelt, and counter-offered to purchase the Merinoffs' shares at the same price. Not surprisingly, the Merinoffs declined this offer. Subsequently Sunbelt became engaged in negotiations for a mutual 15% stock swap with Young's Market, the largest wholesale alcohol distributor in California. Undaunted by Goldring's previous refusal to sell her shares, Merinoff attempted to convince Goldring to give up her 15% stake to facilitate the stock swap. Again she declined.

Following a purchase by the Merinoff family in July of additional Sunbelt shares at a price of \$45.83 per share, again based on the Formula, the Sunbelt board decided to force the issue with Goldring. To that end, the board engaged Hempstead & Co. to prepare a fairness opinion in anticipation of a \$45.83 per share buyout of Goldring's shares. This fairness opinion was prepared over the course of one week, while the senior banker also was working on another matter that required him to be away from his office. Following delivery of the fairness opinion, the Sunbelt board authorized a "freeze-out" merger under Delaware law in which the Merinoffs would retain their shares but Goldring would be cashed out at the Formula price of \$45.83 per share. This merger, which effectively terminated Goldring's ownership interest in Sunbelt without her consent, became effective on August 22, 1997.

In response, Goldring filed two separate actions, which ultimately were consolidated. The first demanded an appraisal of her shares at a price significantly in excess of the Formula price, together with an award of interest, fees, expenses and costs. Goldring also filed an alternative common law action against Sunbelt and the individual members of the board, asserting breach of fiduciary duty and seeking rescission of the merger and an award of rescissory damages in the form of 15% of Sunbelt's wholesale distribution portfolio.

### *The Court's Analysis*

The Court initially pointed out that Goldring's consolidated action consisted of *both* an entire fairness action *and* a statutory appraisal. Moreover, because Sunbelt had not employed procedural devices – such as a special committee of disinterested directors or a majority-of-the-minority shareholder vote – typically employed in freeze-out mergers, the burden fell on the defendants to demonstrate that the merger was entirely fair as to *both* process and price. The Court also noted that "[t]he element of fair price ... relates closely to the determination of fair value under the Delaware appraisal statute." On this basis, the Court proceeded with a traditional entire fairness analysis.

*First*, with respect to the *fair dealing* prong of the entire fairness standard, the Court used particularly strong language to castigate the process employed by the Sunbelt board, labeling the tactics used to gain control of Goldring's shares as "nothing short of strong-armed." As such, the Court found the process to be "anything but fair ... jerryrigged every step of the way and ... transparent in its goal to eliminate Goldring before a stock swap with Young's Market ... at the ... Formula price." The Court was particularly critical of the board's failure to utilize "procedural protections designed to ensure arm's-length bargaining or to approximate

a fair valuation procedure. There was no special committee, no opportunity for genuine negotiations ... and no dissemination of material information that would level the playing field and prevent Goldring from becoming a drastically disadvantaged minority shareholder.” Even the fairness opinion obtained by the board was, in the Court’s opinion, “highly suspect,” a “mere afterthought” and “pure window dressing intended ... to justify the preordained result of the merger at the Formula price of \$45.83 per share.”

*Next*, with respect to the *fair value* prong of the entire fairness standard, the Court, while noting the “evidentiary import Delaware courts have accorded prior transactions in a company’s stock,” rejected the three-year old Formula as irrelevant to a current valuation of Sunbelt.<sup>2</sup> Not only “are there too many variables that can change over three years’ time,” but, according to the Court, the Formula relied too heavily on the book value of Sunbelt, provided a premium related to Sunbelt’s net income in the two years preceding the Formula-based transactions and did not “adequately incorporate the influence of intangibles and good will on the company’s value.” The fact that Goldring herself had, three years earlier, utilized the Formula in her put/call arrangement with another shareholder had, in the Court’s opinion, “absolutely no relation to Goldring’s statutory appraisal rights or to the accompanying valuation methodologies to which Goldring is now entitled under Delaware law.”

The Court then turned to an analysis of the valuation methodologies offered by experts retained by each side, and rejected them all (for a variety of reasons related primarily to their lack of applicability to Sunbelt), other than the experts’ discounted cash flow methodology. Applying the discount rate favored by Goldring’s expert, the Court determined that the fair value of Sunbelt was \$114.04 per share, approximately 2.5 times the price payable to Goldring in the merger.

At the same time, the Court rejected Goldring’s request that she be awarded rescissory damages in the form of assets representing 15% of Sunbelt’s distribution portfolio. In the Court’s view, such a remedy was not appropriate in light of the fact that the cash damages award was “a clearly adequate substitute remedy,” as well as the complexity attendant to valuing, and then unscrambling, Sunbelt’s assets. The Court, however, did award Goldring pre- and post-judgment interest (at the legal interest rate, compounded quarterly), as well as all her court costs and expert witness fees “on the basis of my analysis of defendants’ conduct.” By contrast, because defendants’ valuation was “sufficiently reasoned” and their actions did not “rise to a high level of egregiousness,” Goldring was not awarded her attorneys’ fees.

### **Conclusion**

Typically, care is taken in corporate transactions in which minority shareholders are treated differently from the majority to incorporate procedural devices aimed at ensuring that the transaction will survive an entire fairness analysis. There is no *per se* rule that prohibits the majority from using its superior voting power to “freeze out” the minority; however, courts will not simply defer to such use of majority power, but rather will closely scrutinize the process employed. If, as in *In Re Sunbelt Beverage Corp.*, the court perceives that the process is unfair, then it becomes exceedingly difficult for the majority to carry the burden of establishing both fair dealing and fair price. Clearly, it is incumbent on dealmakers and their legal counsel to resist the temptation to allow the majority to flex its muscle without taking the necessary procedural steps to shift the burden of proving entire fairness to the minority.

<sup>2</sup> According to the Court, while there is “no bright-line rule relating to the maximum length of time” after which a formula would no longer be viewed as persuasive by a court, under “the unusual circumstances here and the nature of this particular business ... three years is far too wide a gap.”

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**Beijing**

Units 05-06, 15th Floor, Tower 2  
China Central Place, 79 Jianguo Road, Chaoyang District  
Beijing 100025, China

Anthony Root +86-10-5969-2777 aroot@milbank.com  
Edward Sun +86-10-5969-2772 esun@milbank.com

**Frankfurt**

Taunusanlage 15  
60325 Frankfurt am Main, Germany

Norbert Rieger +49-69-71914-3453 nrieger@milbank.com

**Hong Kong**

3007 Alexandra House, 18 Chater Road  
Central, Hong Kong

Anthony Root +852-2971-4842 aroot@milbank.com  
Joshua Zimmerman +852-2971-4811 jzimmerman@milbank.com

**London**

10 Gresham Street  
London EC2V 7JD, England

Stuart Harray +44-20-7615-3083 sharray@milbank.com  
Thomas Siebens +44-20-7615-3034 tsiebens@milbank.com

**Los Angeles**

601 South Figueroa Street  
Los Angeles, CA 90017

Ken Baronsky +1-213-892-4333 kbaronsky@milbank.com  
Neil Wertlieb +1-213-892-4410 nwertlieb@milbank.com

**Munich**

Maximilianstrasse 15 (Maximilianhoefer)  
80539 Munich, Germany

Peter Nussbaum +49-89-25559-3636 pnussbaum@milbank.com

**New York**

One Chase Manhattan Plaza  
New York, NY 10005

Scott Edelman +1-212-530-5149 sedelman@milbank.com  
Roland Hlawaty +1-212-530-5735 rhlawaty@milbank.com  
Thomas Janson +1-212-530-5921 tjanson@milbank.com  
Robert Reder +1-212-530-5680 rreder@milbank.com  
Alan Stone +1-212-530-5285 astone@milbank.com  
Douglas Tanner +1-212-530-5505 dtanner@milbank.com

**Singapore**

30 Raffles Place, #14-00 Chevron House  
Singapore 048622

David Zemans +65-6428-2555 dzemans@milbank.com  
Naomi Ishikawa +65-6428-2525 nishikawa@milbank.com

**Tokyo**

21F Midtown Tower, 9-7-1 Akasaka, Minato-ku  
Tokyo 107-6221 Japan

Darrel Holstein +813-5410-2841 dholstein@milbank.com

**Washington, DC**

International Square Building, 1850 K Street  
Washington, DC 20006

Glenn Gerstell +202-835-7585 gerstell@milbank.com