CORPORATE CHRONICLE FROM DELAWARE

It is of no secret that Delaware is the go-to jurisdiction when it comes to registering business entities in the US. To understand the magnitude of Delaware's popularity in this area consider two of the following facts: 1) the number of businesses registered in this state exceeds its overall population. 2) More than 66% of the Fortune 500 companies are incorporated in Delaware. One obvious reason why companies prefer to register in Delaware is its favorable tax regime. Another well-known reason for such preference is the trust in Delaware's corporate law and judicial system. The courts of this state are known for their deep expertise in corporate law matters and over the course of years have developed standards and doctrines that strike a fair balance between interests of stakeholders involved in the corporate arena.

Having this outstanding reputation of Delaware courts in mind, we have decided to dedicate this article to looking over a recent decision of the Delaware Court of Chancery on a major corporate dispute. The case we shall be analyzing is In Re Cellular Telephone Partnership Litigation, where minority shareholders in a partnership sued the giant US telecommunication service provider AT&T for exercising a freeze-out merger and forcefully squeezing them out of the partnership. Our analysis shall be structured as follows: first we shall provide a short summary on the facts of the case and then we shall proceed to discussing two questions related to the case. The questions of our interest will be: Why allow corporate freeze-outs in the first place? What is the optimal remedy for minority shareholders that have been subject to an unfair freeze-out?

Salem Cellular Telephone Company Partnership was a general partnership formed in Delaware that had a license to provide cellular telephone services in Salem, capital of the state of Oregon. Before squeezing out minority shareholders from the partnership, AT&T indirectly held around 97% interest in the partnership and the minority shareholders held the rest. In the late 2000s it was estimated that revenue from data services and related business would be skyrocketing, which also meant paying more distributions to minority shareholders in the future. AT&T management figured it would be much cheaper to buy back minority shares at that time than to continue with distribution payments or to buy back minority shares in the future. As quoted by one of the executives of AT&T, "a buyout today will be much less expensive than 1 or 2 years down the road given OIBDA growth rates". In fact, this strategy was applied not only to the Salem Partnership but to a number of other partnerships owned by AT&T. In order to save on the distributions attributed to minority shareholders, AT&T started to plan the buy-out and retained PwC to value thirteen partnerships, including the Salem Partnership. PwC estimated that the value of the Salem Partnership was $219 million. It was estimated that the value of minority partners' interests in all partnerships was $130 million, which was much lower than the $243 of the distributions that the buy-outs would help to avoid, as estimated by AT&T.

AT&T proposed to acquire minority interest at a 5% premium over the value determined by PwC, however, the same offer also stated that if minority partners decline it, AT&T would vote for selling the Partnership's assets and liabilities at the price equal to the Partnership's value determined by PwC. Essentially, minority partners had to choose between the following: agree with AT&T's offer and receive the value of their interest, as valued by PwC, and a 5% premium, or decline the offer and receive the value of their interest without the 5% premium. Some of the partners accepted the offer and left the partnership, however, the majority of the minority partners (around 58% of all minority partners) refused to accept the offer. As a result, AT&T's next step was to initiate a meeting of partners in order to vote for selling all the assets and transferring all liabilities of the Salem partnership to New Salem for $219 million. AT&T's vote on its own was sufficient to approve the transaction. After the transaction was executed, the Partnership was dissolved and the minority shareholders received their pro rate share of the sale price ($ 4,119,390 in the aggregate).

Dissatisfied with the transactions, minority partners sued AT&T for breach of fiduciary duties, namely the duty of loyalty. Depending on the circumstances, while examining cases on breach of fiduciary duties, Delaware courts apply different standards and tests for reviewing the facts. Generally, transactions with conflict of interest, warrant a stricter standard of review. In this case the freeze-out transaction involved a conflict of interest, because AT&T stood on both sides of the transaction. This triggered the court to apply the entire fairness review. Under this standard, AT&T must prove "to the court's satisfaction that the transaction was the product of both fair dealing and fair price". It is important to highlight that "the transaction itself must be objectively fair, independent of the fiduciary's beliefs."

As determined by the court, AT&T failed to overcome the entire fairness test for the following reasons:

- AT&T exercised the freeze-out right before the revolution in the data business that would contribute to the increase of the partnership's profits and as a result lead to the increase in distributions to be paid to the minority partners
- PwC had prior connections with AT&T
- AT&T offer regarding the 5% premium was coercive
- The court found a number of significant flaws in the valuation process and the methodologies applied

Consequently, the court ruled out that minority partners were entitled to compensation.

At this point, a simple yet an important question may arise: why allow corporate freeze-outs in the first place?

Taking into account that protection of minority shareholders is a fundamental principle in corporate law, it may be tempting to favor an absolute legislative ban of a freeze-out. Instead of developing various tests and methodologies to assess the fairness of the buy-back price, policymakers could forbid such transactions and favor reversal of the freeze-out transaction as the primary remedy for minority shareholders.

However, that is not the case in Delaware and many other major jurisdictions. It has to be noted that such policy has a number of valid justifications.

Firstly, entrance of minority shareholders creates certain restraints on the freedom of majority shareholders to manage the company, as well as opens up to a major legal exposure. For example, the company may be willing to engage in a risky or non-conventional business endeavor, which may not be in line with fiduciary duties owed to the minority shareholders. Consider the example of the well-known Dodge vs. Ford case, where Dodge brothers, as minority shareholders sued Ford Motor Company for constant failure to pay adequate dividends. As Mr. Ford puts it, his ambition is “to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this we are putting the greatest share of our profits back in the business.”. The Court did not fully agree with this statement and ruled to the contrary stating that interests of the shareholders cannot be sacrificed in order to produce cheap cars for the public and pay high salaries to employees. If majority shareholders are willing to pursue a risky business strategy, without the risk of being involved in any litigation commenced by minority shareholders, and are willing to pay a fair compensation, little justification, if any, could be provided for prohibiting such transaction.

Secondly, presence of minority shareholders complicates the process of selling the company. The potential buyer may be interested in being the sole owner of the company or having partners that are from his own circle of friends due to reasons outlined in the first point. Presence of minority shareholders may be a deal-breaker for potential buyers. Exercising a corporate freeze-out in such circumstances would save the deal.

The second topic we shall touch upon is related to the remedy that holders of minority interests in the Partnership were entitled to. As a remedy plaintiffs were claiming the present value of the distributions they would have received if the freeze-out never happened. Essentially, plaintiffs demanded to use the analogue of the Dividend Discount Model (DDM) for valuing the partnership. However, this approach was partially denied by the court. Instead, the court sought to determine the fair value of the interests, held by minority partners before the freeze-out, using the DCF method, the same method that was applied by PwC and the expert hired by AT&T for the purposes of this litigation. At the same time, to the extent possible the court removed the errors in the application of the DCF method that took place when the majority partner’s experts valued the partnership. Applying the DCF model using certain adjustments to account for the errors, the court concluded that the reasonable estimate of the Partnership’s value before the Freeze-out was $714.039.606.48 and the plaintiffs were entitled to 1.881% of that amount ($13.431.085), which is around $ 9 million more than what they had received against the freeze-out.

The topics we shall discuss regarding the remedy awarded are as follows: 1) Did the remedy create sufficient incentives to discourage majority shareholders (partners or other equivalent interest holders) from engaging in freeze-outs to appropriate the future income that minority shareholders were entitled to? 2) Some thoughts on what is an optimal remedy for minority shareholders in freeze-outs?

The facts of the case do not allow us to come to specific conclusions with respect to the first question. Namely, the case opinion cites that AT&T's analysis of 21 entities, including the Partnership, predicted a present value of 128.4$ million of savings of the avoided future distributions. However, the opinion does not specify how much savings on distributions to minority interest holders would the buyout of the Partnership create. In order to understand whether under the circumstances of the present case, would AT&T still be economically motivated to execute the buy-outs, one must calculate whether AT&T's expected savings on the distributions were less than the aggregate amount of the buy-out price and the damages paid to minority partners as a result of the lawsuit at hand. If the AT&T's expected savings would still be higher than what the minority partners received as a result of the buy-out (including damages), then it would still have incentives to pursue the policy of ousting minorities.

The second point warranting attention is that under circumstances similar to this case majority owner's expected distributions might not be in line with the estimated distributions an average impartial analysis would render. Its forecast could be higher due to internal information and may later prove to be more accurate. After all a majority shareholder is better informed about its company, potential and future business plans than a valuation company. Alternatively, it could be higher due to biased optimism and later prove to be inaccurate. This leads us to the thought on whether judicial decisions or statutory rules shall be targeted at punishing wrongful intentions of majority interest holders or should they be aimed at ensuring that minority shareholders are not ripped of their future income? Assume that representatives of the majority shareholder have held internal discussions and believe that exercising a buy-out at a certain price would allow to save 1000$ on distributions. Independent valuations expert has a much lower forecast. As a compensation, should minority shareholders be entitled to the 1000$, as expected by the majority shareholder, or to the lower amount determined by an independent valuation expert? Punishing based on expectations, without evaluating the reasonableness of such amounts, is relatively straightforward but can often create inefficiencies. If we consider the efficient breach theory, a party to a transaction shall be encouraged to breach the transaction if doing so and paying damages to the other party would be more efficient. Regarding the freeze-out, placing a burden that is higher than the damages suffered by minority shareholders may discourage freeze-outs in circumstances where they would be more efficient than keeping minorities in the business.