

CORPORATE LAW

The Corporate Freeze-Out

Obtaining control of your company

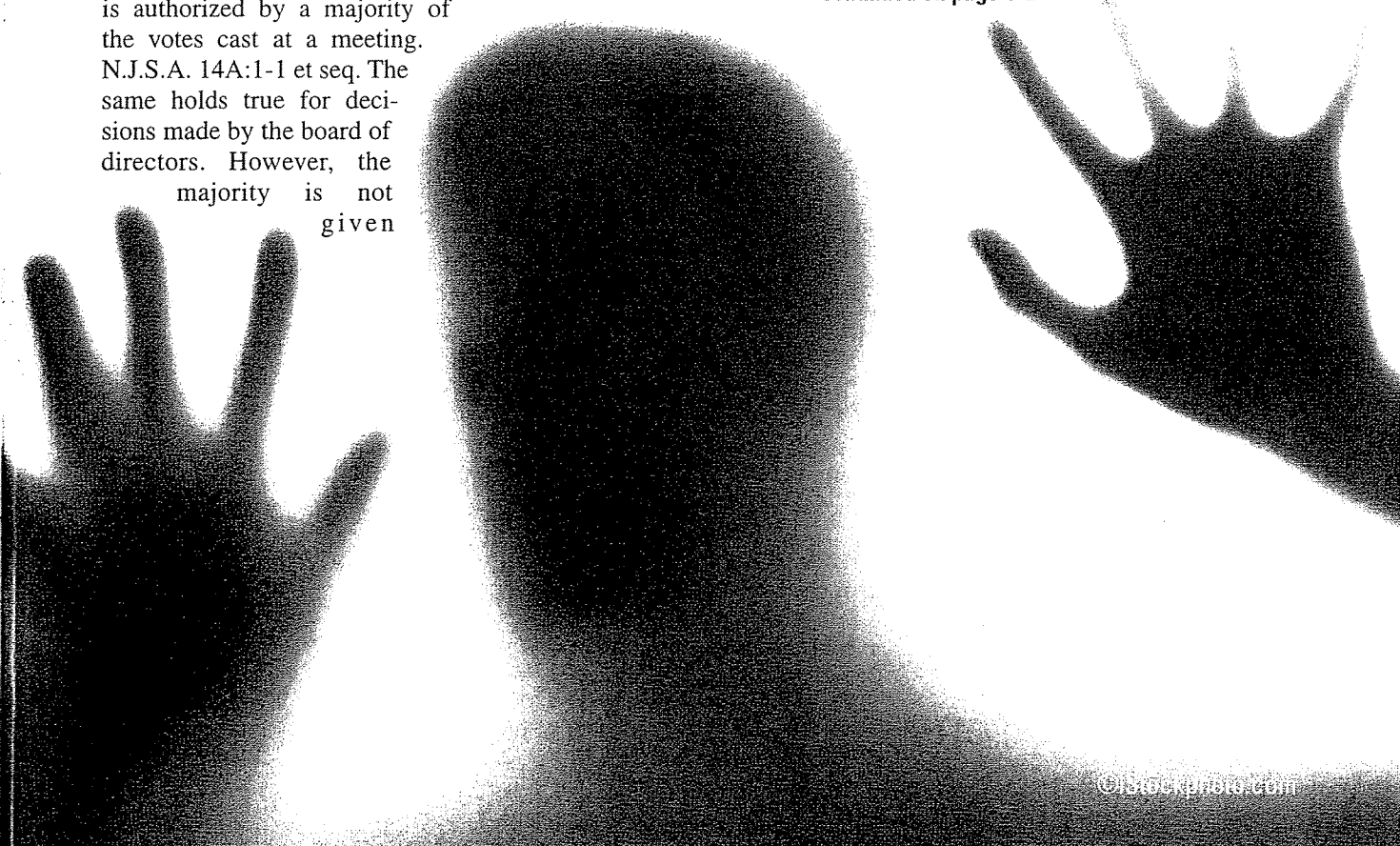
By Peter Greenbaum and Alyson M. Leone

Simply stated, the majority rules. Under the New Jersey Business Corporation Act, unless otherwise required by such act, a corporation's certificate of incorporation, bylaws or shareholders' agreement, an action by the shareholders is authorized by a majority of the votes cast at a meeting. N.J.S.A. 14A:1-1 et seq. The same holds true for decisions made by the board of directors. However, the majority is not given

unfettered control over the corporation. Minority shareholders receive heightened protection under New Jersey law.

The "oppressed shareholder statute" permits the court to "appoint a custodian, appoint a provisional director, order a sale of the corporation's stock ... or enter a judgment dissolving the corporation upon proof that ... in the case of a corporation having 25 or less shareholders, the directors or those in control have acted

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fraudulently or illegally, mismanaged the corporation, or abused their authority as officers or directors or have acted oppressively or unfairly toward one or more minority shareholders in their capacities as shareholders, directors, officers, or employees." In the case of a court-ordered sale of the stock held by a shareholder, the purchase price of the shares must be the fair value. Further, New Jersey law protects the minority shareholder through "dissenters rights," which permits a shareholder to dissent from a vote of the shareholders with respect to certain proposed corporate acts and "make written demand on the corporation ... for the payment of the fair value of his shares."

Often, the majority owners of a closely held corporation lose control of their business to the minority owners. The owners may not see eye-to-eye on certain strategic decisions of the business; may possess differing opinions on the long-term goals of the business; or may just not agree on the most fundamental issues relating to the business. A prepared majority owner will hopefully have anticipated this issue and taken steps to protect himself in advance. An agreement amongst the shareholders (or buy-sell agreement) is the best way to document and evidence the parties' understanding and expectation to avoid disagreement in the future. For example, a provision may be included in a shareholder agreement that gives the majority owner the right to acquire the minority owner's shares in certain circumstances or "drag along" the minority owner in other circumstances. Unfortunately, even the most com-

prehensive shareholder agreement or sophisticated majority owner may not contemplate every possible event.

A majority owner in such a position may elect to continue to remain in such an undesirable relationship or may fall back upon certain statutory rights, which have the effect of freezing-out the minority owner. This article focuses on the steps to be taken by a majority owner to effectuate a freeze-out by means of a merger.

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Corporate freeze-outs are subject to judicial scrutiny, as ultimately the end result of the freeze-out is to strip the minority owner of his ownership. Thus, before commencing the process, the majority owner should be careful to structure the freeze-out to comply with New Jersey's statutory scheme for mergers and fiduciary obligations.

The first step in the freeze-out process is for the majority owner to obtain an appraisal of the corporation. The reason behind the appraisal is two-fold. First, the minority owner is permitted under both the "oppressed shareholder statute" and the "dissenters rights" statute to demand the fair value of his shares. Thus, the majority owner must calculate the potential

value to be paid out to the minority owner. Second, the majority owner must confirm that the corporation is financially able to make such payment and, just as important, financially able to make such payment in cash when a deal is reached or it is judicially determined that same must be paid.

Next, the majority owner must determine whether he wants to negotiate a (hopefully) amicable buy-out by approaching the minority owner (instead of proceeding directly to the freeze-out process). By approaching the minority owner prior to commencing the freeze-out, a potentially contentious and costly process may be avoided. Conversely, by giving the minority owner insight into his ultimate goal (that is, a buy-out), the majority owner may be tipping his hand regarding his next step, thus giving the minority owner time to prepare for the freeze-out process.

If the majority owner decides to proceed with the freeze-out process, whether it is due to an unsuccessful buy-out negotiation with the minority owner or a decision to bypass such negotiation process, careful structuring of the freeze-out is imperative. Generally, a freeze-out consists of the formation of a new corporation (Newco) which is wholly owned by the majority owner, the merging of the jointly owned existing corporation (Existingco) into Newco and the payment of fair value to the minority owner for his shares in Existingco in lieu of a proportionate number of shares in Newco.

Prior to the merger, the majority owner must conduct a due diligence investigation of Existingco's operations and the proposed restructure to confirm that an unintended adverse consequence will not occur as a result of the freeze-out. Numerous areas

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must be analyzed. For example, Existingco's agreements must be reviewed to determine whether a merger will trigger a default or require the consent of a third party. It is not unusual for financing agreements, lease agreements, and the like to contain provisions in which a merger or change of ownership triggers a default or requires a third party's consent. Additionally, the transaction must be analyzed from a tax perspective to confirm an adverse tax consequence will not occur due to the consummation of the merger.

Newco must then prepare for the merger. First, Newco must be formed. Then the majority owner must prepare a plan of merger. The plan of merger must include, among other things, the manner and basis of converting the shares of Existingco into shares of Newco, in the case of the majority owner, and into cash or property, in the case of the minority owner.

Next, the board of directors of Newco must approve the plan of merger. The appraisal of the fair value of Existingco (which should have been obtained at the beginning of the process, as discussed above) should be read into the minutes of the board meeting, as it relates to the cash to be paid to the minority owner. After the board of Newco has approved the proposed transaction, it must then be submitted to the shareholders of Newco for approval by a majority vote. Although the foregoing is a formality in some respects (as the majority owner presumably is the sole director of Newco and owns all of the outstanding shares of Newco), it is important that the appropriate corporate procedures be followed since in the event litigation ensues, Newco's corporate action with respect to the merger will be critically analyzed.

The same plan of merger and board and shareholder approval must be conducted in Existingco. Thus, Existingco's board must call a meeting for the purpose of considering and voting on the proposed merger. Just like with Newco, it is important that the meeting is duly called and the req-

uisite notice to directors is provided in accordance with Existingco's bylaws and the New Jersey Business Corporation Act. In addition, the board of Existingco must approve the terms and conditions of the proposed merger, including the manner and basis of converting the outstanding shares of Existingco into shares in Newco for the majority owner and cash for the minority owner. Again, the

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previously obtained valuation should be read into the minutes as a basis for converting the minority owner's shares into cash.

After being approved, the board must submit the plan to a vote at a meeting of the shareholders. Written notice to each shareholder of Existingco must be given not less than 20 nor more than 60 days before such meeting whether or not such shareholder is entitled to vote at the meeting. The notice must contain a copy or summary of the plan of merger and include a statement informing the shareholders of their right to dissent and be paid the fair value of their shares (i.e., "dissenters rights"). In addition, the notice must outline briefly the procedures with which each shareholder must comply in order to dissent to the merger, with particular reference to the time period within which such actions must be taken. The proposed plan of merger must be approved by a majority of the votes of the outstanding shares.

Once the board and shareholders of Existingco and Newco have approved the proposed plan of merger, all that is left is to consummate such merger. This is accomplished pursuant to the customary merger procedures, including the preparation of a certificate of merger which sets forth, among other things, the name of the surviving entity, the plan of merger, the date upon which the shareholders of each corporation approved the merger, the number of shares entitled to vote and the number of shares voting for and against the merger.

The certificate of merger must then be filed in the office of the New Jersey Department of Treasury. The merger becomes effective upon the date of filing or at such later time as set forth in the certificate, not to exceed 90 days after the date of filing. Finally, the fair value of the shares held by the minority owner must be paid and the stock certificate held by him must be retrieved and cancelled.

It should be noted that, as indicated in the notice to the shareholders of Existingco, shareholders are statutorily provided dissenters rights, which means that they possess the right to dissent from the proposed merger transaction and to be paid the fair value for their shares. The specific procedures with which a shareholder must comply to assert his dissent and be paid the fair value for his shares is beyond the scope of this article. However, the end result thereof is similar to the freeze-out, which is to pay the minority owner the fair value for his shares.

Although the freeze-out process is simple to describe, as with many other corporate actions, the "devil's in the details." There are a number of factors a majority owner should contemplate when deciding whether to proceed with a freeze-out and ultimately strip the minority owner of his shares. Thus, it is imperative that the majority owner consult with legal and accounting professionals before going forward with the freeze-out. ■