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M&A Freeze-Out Ruling Underscores Minority Investor Rights

By **Stephen Younger and Danielle Quinn** (August 13, 2020, 4:46 PM EDT)

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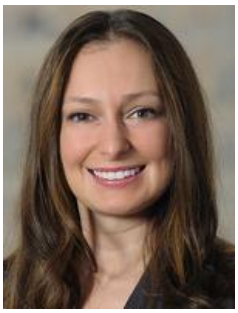

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On July 13, in Van Horne v. Ben-Dov, Justice Jennifer Schecter of the New York County Commercial Division preliminarily enjoined a New York City real estate company's contemplated freeze-out merger.

The court's reasoning was that the majority shareholder had failed to show a legitimate corporate purpose that would be achieved by the proposed merger.[1] This ruling follows a trend in this area in the Commercial Division.

Freeze-out mergers are corporate transactions resulting in a merger of two entities that force minority shareholders to sell their stock in exchange for a cash buyout. To effectuate a freeze-out merger properly, the majority shareholders must comply with the New York Business Corporation Law, the terms of the company's certificate of incorporation, and perhaps most importantly, the majority shareholder's fiduciary obligations to the company.[2]

The typical remedy available to a minority shareholder who opposes a freeze-out merger is to pursue an appraisal proceeding to value the minority shareholder's equity in the corporation and obtain a cash buy-out.[3] If a court determines that the proposed merger is fraudulent, unlawful or breaches fiduciary duties, it may grant other equitable relief.[4]

The majority shareholders' fiduciary obligations to the corporation remain intact during the freeze-out merger process.[5] These fiduciary duties require the majority shareholders to discharge all corporate responsibilities in good faith, "with conscientious fairness, morality and honesty in purpose."[6]

The court's role in reviewing a freeze-out merger is to determine whether "the transaction, viewed as a whole, was 'fair' as to all concerned" by looking to see whether the majority shareholders followed "a course of fair dealing toward minority holders," and whether they "offered a fair price for the minority's stock."[7]

Of course, the purpose of the freeze-out merger is to cash out the minority shareholder's interest in the corporation, which often leaves minority shareholders to question the fairness of the transaction. With this consideration in mind, "variant treatment of the minority shareholders — i.e., causing their removal

— will be justified when related to the advancement of a general corporate interest."[8]

In a recent Commercial Division decision, Van Horne v. Ben-Dov, Justice Schecter ruled that a proposed freeze-out merger lacked a corporate business purpose.[9] Justice Schecter relied on the New York Court of Appeals' leading decision in Alpert v. 28 Williams St. Corp., which outlines the corporate interest requirement.[10] In Alpert, the court of appeals explained that:

> The benefit need not be great, but it must be for the corporation. ... What distinguishes a proper corporate purpose from an improper one is that, with the former, removal of the minority shareholders furthers the objective of conferring some general gain upon the corporation. Only then will the fiduciary duty of good and prudent management of the corporation serve to override the concurrent duty to treat all shareholders fairly.[11]

In Van Horne, the majority shareholders' asserted corporate benefit for the freeze-out merger — i.e., to avoid a purported entanglement by the corporation in a divorce litigation — was not a legitimate corporate purpose.[12] Justice Schecter ruled that there had been no showing by the majority shareholder that the trust which owned the minority shares could be impacted by the divorce case.[13]

Instead, the court determined that this divorce proceeding justification was just a pretext for the freeze-out merger, given that it had been raised for the first time in the majority shareholders' opposition to the preliminary injunction request. Justice Schecter concluded that, particularly given that the company was a single-purpose vehicle that held a long-term commercial lease, the company would gain nothing from a freeze-out and this after-the-fact justification could not be used to justify the proposed merger.[14]

The Commercial Division held that because "[n]o actual corporate benefit [was] stated and there is no evidence that proper business judgment was exercised," the minority shareholders had demonstrated a likelihood of success on the merits.[15]

The court further determined that no irreparable harm would flow from granting the injunction because the corporation — a real estate corporation that pays out shares to its shareholders — would remain unaffected by the injunction; and even if the injunction were to be lifted, the end result in both instances would be a valuation proceeding regarding the minority shareholders' interest under New York Business Corporations Law Section 623(e).[16]

Accordingly, the court preliminarily enjoined the majority shareholders from conducting a freeze-out merger.

Justice Schecter's ruling in this case — requiring the majority shareholders to articulate a benefit to the corporation achieved by a freeze-out merger — is one of a growing number of such rulings by the Commercial Division that are protective of minority shareholders.[17] That is, the justices of the New York County Commercial Division have issued several decisions that closely scrutinize the proposed benefits to shareholders and the corporation itself in evaluating both freeze-out mergers and nonmonetary settlements of merger challenges — which are mechanisms that often benefit majority shareholders.

There are several background factors driving this trend.

First, the U.S. Supreme Court's 2018 decision in Cyan Inc. v. Beaver County Employees Retirement

Fund[18] opened the door for putative class action shareholders to file federal securities claims against securities issuers and underwriters in state courts, such as the Commercial Division. The Cyan decision increased the volume of such shareholder cases that are litigated in state courts, and made New York's Commercial Division a beneficial forum in which to file complex securities cases.

Of note, following Cyan, Justice Schecter made clear her openness to taking on complex securities cases. In the Matter of GreenSky Inc. Securities Litigation, Justice Schecter denied the defendants' motion to stay a state court action pending resolution of a later-filed federal case which involved virtually identical claims under the Securities Act of 1933.[19]

In GreenSky, Justice Schecter held that where a 1933 action is first filed in state court, staying that action in deference to a later-filed federal action is not appropriate absent good cause for doing so. The decision reasoned that "pre-Cyan most 1933 Act cases were brought in [federal court] thus, those courts undeniably have more experience dealing with securities litigation," but that state courts are "just as capable" of doing so.[20]

Cyan thus marked a shift in the Commercial Division's willingness to hear more securities actions that otherwise would have been filed in federal court.

Second, the First Department's holding in Gordon v. Verizon Communications, Inc.[21] changed the landscape in the Commercial Division for how nonmonetary settlements of putative shareholder class actions are evaluated. Prior to Gordon, both the New York and Delaware courts viewed nonmonetary settlements as a merger tax because shareholders would frequently bring nonmeritorious challenges, the settlement of which generated significant attorney fees, but were of little value to either the shareholders or the corporations.

The First Department's decision in Gordon added two new factors for courts to consider in deciding whether to approve a nonmonetary settlement of a shareholder challenge to a corporate merger: (1) whether the agreement is in the best interests of the members of the putative class of shareholders, and (2) whether the proposed settlement is in the best interests of the corporation.[22]

Since Gordon, the justices of the Commercial Division have closely evaluated these new requirements for assessing a proper premerger settlement — i.e., that the interests of the putative class shareholders and the corporations must be served in some way.

For example, in City Trading Fund v. Nye, Justice Shirley Werner Kornreich, then of the Commercial Division, reviewed a class action settlement to determine whether the agreement was in the best interests of the members of the putative class of shareholders, and twice declined to grant approval, determining that there was no benefit in the settlement for the company or its shareholders.[23]

This decision was among the first Commercial Division decisions to apply the "some benefit" standard for reviewing class action settlements that was articulated by the First Department in Gordon. The City Trading decision underscored that even under the some-benefit test for approving class settlements, there must be some articulable benefit to class members in order to warrant such approvals.

Then, in the fall of 2019, Justice Barry Ostrager of the Commercial Division issued a ruling in In re: Xerox Corporation Consolidated Shareholder Litigation, declining to certify a proposed class and refusing to approve a proposed settlement.[24]

In considering the new Gordon factors — i.e., whether the settlement "in the best interests of the putative class as a whole, and whether the settlement is in the best interest of the corporation" — Justice Ostrager determined that the putative class members would receive no financial benefit from the settlement.

Rather, "[t]he net result of the actions of the purported class representatives and purported class counsel was to transfer control of a public corporation to [two shareholders] via a private agreement that offered no tangible benefit to the interests of the class" shareholders.[25]

The Commercial Division also reasoned that the putative class members "are being asked to 'give' broad releases of any derivative claims they may have."[26] As a result, the court declined to approve the proposed settlement.

The City Trading and Xerox shareholder litigation decisions are just two examples of how the justices of New York's Commercial Division will carefully scrutinize a proposed settlement offer that could potentially disadvantage minority shareholders. Following this trend, Justice Schecter's recent decision in Van Horne is further evidence that the Commercial Division is willing to enjoin a freeze-out merger where there is no evident corporate benefit to the transaction.

The takeaway here is thus that, as more shareholder and securities cases work their way through the Commercial Division, the court will not simply rubberstamp actions by corporations or their majority shareholders that may jeopardize the rights of minority shareholders. This is particularly evident in the context of freeze-out mergers and nonmonetary settlements.

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[1] Van Horne v. Ben-Dov, Index No. 652444/2020, NYSCEF Doc. No. 35 (Sup. Ct., N.Y. Cnty. July 13, 2020).

[2] Craig Weiner & Lisa Coyle, Freeze-Out Mergers Involving Closely Held New York Companies, Avoiding Pitfalls, Bloomberg Law (Feb. 28, 2019) at 2.

[3] Alpert v. 28 Williams St. Corp., 63 N.Y.2d 557, 567-68 (1984).

[4] Id. at 568.

[5] See id.

[6] Id. at 569 (quoting Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 193 (1919)).

[7] Id. (citations omitted).

[8] Id. at 573.

[9] Van Horne. v. Ben-Dov, Index. No. 652444/2020, NYSCEF Doc. No. 35, at 1.

[10] Id.

[11] Alpert., 63 N.Y.2d at 573.

[12] Van Horne v. Ben-Dov, Index. No. 652444/2020, NYSCEF Doc. No. 35, at 1-2.

[13] Id.

[14] Id. at 2.

[15] Id.

[16] New York Business Corporations Law § 623(e) is the statutory provision that controls such "fair value" proceedings in New York. These proceedings determine the value of a dissenting shareholder's interest in a corporation for purposes of a buyout of that interest.

[17] Commercial Division Enjoins Xerox-Fujifilm Deal Resulting In Resignation of Xerox's CEO, https://www.pbwt.com/ny-commercial-division-blog/commercial-division-enjoins-xerox-fujifilm-deal-resulting-in-resignation-of-xeroxs-ceo/ (May 4, 2018), and First Department Reverses Against Ending Fuji-Xerox Merger, https://www.pbwt.com/ny-commercial-division-blog/first-department-reverses-against-ending-fuji-xerox-merger (Oct. 18, 2018).

[18] Cyan, Inc., et al. v. Beaver County Employees Retirement Fund, 138 S. Ct. 1061 (2018).

[19] Matter of Greensky, Inc. Sec. Litig., 2019 NY Slip Op. 33515(U) (Sup. Ct., N.Y. Cty. Nov. 25, 2019).

[20] Id. at *2.

[21] Gordon v. Verizon Commc'n, Inc., 148 A.D.3d 146, 154 (1st Dep't Feb. 2, 2017).

[22] Id. at 158.

[23] See City Trading Fund v. Nye, 59 Misc. 3d 477, 489-491 (N.Y. Sup. Ct., N.Y. Cty. 2018); City Trading Fund v. Nye, 144 A.D.3d 595 (1st Dep't 2016).

[24] No. 650766/2018, NYSCEF Doc. No. 997, at 13.

[25] Id. at 14.

[26] Id. at 13.