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Expert Analysis

Wesco Financial Ruling has Lessons for Controlling Stockholders In Freeze-out Transactions

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The Delaware Chancery Court's recent denial of plaintiff shareholder's motion for preliminary injunction in *Krieger v. Wesco Financial Corp.*, No. CA6176-VCL (May 10, 2011), provides useful guidance regarding the process and dynamics for controlling stockholder freeze-out transactions under the new *CNX Gas* standard.

The company's easy victory at the preliminary injunction hearing demonstrates the power, from the perspective of establishing fair dealing, when the freeze-out transaction is both negotiated and approved by a special committee of independent directors, the deal is conditioned on affirmative vote of a majority of the minority stockholders, and the majority shareholder emphasizes there will be no hard feelings if the special committee or minority shareholders decline the offer.

HISTORY

Wesco is a purported class action brought on behalf of the public shareholders of Wesco Financial Corp. challenging Berkshire Hathaway's proposed acquisition of the 19.9 percent of the shares of Wesco's common stock that Berkshire does not presently own in exchange for cash or Berkshire shares, at the election of each Wesco shareholder. The transaction value of the 19.9 percent of Wesco not owned by Berkshire is about $550 million.

Wesco was founded in 1925 as a savings and loan. In the early 1960s, Berkshire helped Wesco's founding family defend against a hostile takeover. Since 1977 Berkshire has owned 80.1 percent of the Wesco common stock.

Wesco discontinued its savings and loan operation in 1990 and pursued a diversification strategy. Currently, Wesco owns CORT, the nation's largest furniture rental company. Wesco also operates insurance and steel service center businesses and engages in investment and real estate activities.

Wesco's chairman, president and CEO, Charles Munger, is vice chairman of Berkshire. Wesco's filings with the Securities and Exchange Commission state that Munger consults with Warren Buffett, the chairman of Berkshire, about the company's investments and decisions regarding major capital allocations.

Berkshire managed Wesco's insurance and investment operations and allocated several highly desirable opportunities, including Berkshire's investments in Goldman Sachs and Wm. Wrigley, to the company. However, Wesco's operating businesses performed poorly.

CORT has been unprofitable for seven of the last 10 years. The steel service center business is a small player in a highly fragmented market that contributes negligibly to Wesco's earnings. The real estate division invested in a luxury condo building at the peak of the market, and Wesco is unlikely to recover its investment for some time.

Needless to say, Berkshire's growth in book value per share has substantially outperformed Wesco's during the past decade.

According to the plaintiff's complaint, Munger, the chairman of Wesco and vice chairman of Berkshire, stated in a Feb. 26, 2010, letter to Wesco stockholders:

> Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth "easier." Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's extrinsic merits has, in recent years, continued to widen in favor of Berkshire Hathaway.

On Aug. 18 Buffett began considering whether to propose a transaction to acquire the 19.9 percent of Wesco common stock that Berkshire did not already own. At the time, Wesco common stock was trading at a 20 percent discount to its book value, which Buffett considered to be a fair representation of its intrinsic value.

BERKSHIRE'S AMENDMENT

Berkshire amended its Schedule 13D Aug. 26, publicly announcing its intention to make a proposal to acquire the 19.9 percent of the shares it did not already own.

The Wesco board held a special meeting Sept. 1 to discuss Berkshire's amendment to its Schedule 13D. At the meeting, the board reviewed a formal written offer from Buffett to acquire the common stock for a price equal to Wesco's book value at closing.

Buffett's letter is a textbook example of how a majority shareholder should present a freeze-out proposal. The letter provided:

- The transaction would be tax-free for any Wesco shareholder who wants it to be. Each Wesco shareholder would be able to choose between Berkshire class B common stock or the cash equivalent, in whatever proportion he or she chose.
- Given the relationships between Wesco and Berkshire, Buffett expects the Wesco board to appoint a special committee to consider the proposal. Berkshire will not move forward unless the transaction is approved by the special committee.
- Berkshire will not do a transaction unless it is approved by a vote of the majority of the shares not owned by Berkshire.
- If the special committee or holders of a majority of the minority shares do not approve the deal, "there will be no hard feelings on our part." The companies

> will continue to have the same relationship they enjoy today, with present management working to increase its value in a manner that benefits equally both Berkshire and public shareholders.

The Wesco board immediately created a special committee of three directors whom the board determined to be independent. Based on the information available to date, it appears that the committee ran a textbook example of the appropriate process. The committee interviewed five law firms and retained Skadden Arps as its legal counsel. The committee, with Skadden's assistance, interviewed six investment banking firms and selected Greenhill & Co. as its financial adviser.

After discussions with Skadden, the special committee determined that no significant conflicts existed that would impair the committee's ability to act in the best interests of Wesco's unaffiliated shareholders.

DEAL APPROVED

The committee met at least 10 times with its legal and financial advisers to discuss the transaction and the status of the due diligence and financial analysis. It sent a counteroffer to Buffett Jan. 20, seeking a price in excess of Wesco's book value. The next day, Buffett rejected any proposal that would require him to increase his price.

The committee ultimately approved the deal and a merger agreement that contained a nonwaivable "majority of the minority" provision requiring the transaction be approved by a majority of Wesco's shares, excluding those owned by Berkshire and its affiliates.

The merger agreement also required Berkshire to vote its shares in favor of the deal and not to terminate the special committee or modify its authority or current membership before closing or termination of the merger agreement.

Finally, the agreement permitted Wesco's board to modify or withdraw its recommendation with respect to the transaction.

MULTIPLE STANDARD TENSION

In *In re CNX Gas Corp. Shareholder Litigation*, 4 A.3d 397 (Del. Ch. May 25, 2010), Vice Chancellor Travis Laster addressed the tension in Delaware law arising from the prior use of different standards of review depending on how the controlling stockholder freeze-out is structured.

Under *Kahn v. Lynch Communication Systems*, 638 A.2d 1110 (Del. 1994), the negotiated merger is reviewed for entire fairness, although the burden of proof can be shifted in favor of the controlling stockholder through the use of a special committee bargaining at arm's length.

In contrast, under *In re Siliconix Inc. Shareholder Litigation*, 2001 WL 716787 (Del. Ch. June 19, 2001), a controlling stockholder's unilateral tender offer followed by a short-form merger is reviewed under a far less onerous standard because neither the tender offer nor the short-form merger, reviewed independently, is subject to entire-fairness review. The ability of the *Siliconix* structure to avoid an entire-fairness review under *Lynch* depends on the absence of a fairness review for the back-end short-form merger.

In *CNX Gas* Vice Chancellor Laster thoughtfully reviewed the doctrinal conflict between the *Lynch* and *Siliconix* standards and decided to adopt the unified review standard suggested in *dicta* by Vice Chancellor Leo Strine in *In re Cox Communication Inc. Shareholder Litigation*, 879 A.2d 604 (Del. Ch. 2005).

Under the *CNX Gas* unified standard, the business judgment rule presumptively applies when a freeze-out transaction is *both* negotiated and approved by a special committee of independent directors *and* conditioned on the affirmative vote of a majority of minority stockholders.

PROCESS GETS DEFERENCE

Vice Chancellor Laster's approach in *CNX Gas* gives judicial deference to processes that simulates arm's-length third-party transactional approvals. The use of both struc-tural protections results in the controlling stockholder standing only on one side of the transaction: as the buyer.

The judge concluded that the unified standard of review gives the independent directors and unaffiliated stockholders "the tools to negotiate with controllers, backstopped by meaningful judicial review for fairness when those tools are withheld."

The Wesco case provided Vice Chancellor Laster with the opportunity to revisit the *CNX Gas* unified standard and to address ancillary issues. At the May 10 preliminary injunction hearing, he found that the transaction satisfied both prongs of the *CNX Gas* unified standard and therefore denied the application for preliminary injunction.

CONCLUSION

Given the procedural fairness of Buffett's proposal and the strength of the committee's process, the plaintiff had a difficult time challenging the protection of the *CNX Gas* standard at the hearing. However, the plaintiff sought to exclude Elizabeth Peters, a director and committee member and member of the company's founding family with 5 percent of the outstanding stock, from voting on the transaction.

The plaintiff argued that Peters should be excluded from the majority-of-the-minority vote because she was on the special committee, had a large block of shares and was allegedly biased in the transaction. Vice Chancellor Laster commented during oral argument that "just as an aside, generally we like long-term holders."

He further noted "Honestly, that strikes me as a good thing. … What I want [as a small stockholder] is to know that there is somebody who is a big holder that was in the game, that was supervising things and that they're getting the same stuff I am. That person who's got a lot on the line and was involved and had the ability to actually influence the process, they are happy and I am free-riding on their efforts."

The plaintiff also argued that Peters was biased insofar as she admired Buffett. One may assume that sterilizing all minority shareholders who admire Buffett would result in a very small turnout at the stockholders' meeting. Vice Chancellor Laster found no colorable argument, based on the current record, for excluding Peters from the majority-of-the-minority vote.

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