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Landmark 2020 Judgment Elucidates Going Private Transactions

When we survey the Israeli M&A scene of 2020, what stands out alongside the many successful exit transactions is a judgment of the Tel Aviv District Court (Economic Division) regarding going private transactions. In August 2020, Judge Ruth Ronen handed down a landmark verdict denying a motion for class action certification relating to the acquisition of the minority shares of Osem Investments Ltd., Israel's largest food manufacturer, by its parent company Nestle S.A., the world's largest food manufacturer.[1] The comprehensive 250-page decision carefully weighs each of the plaintiff's many claims against the integrity of the transaction process and the fairness of the price and elucidates various standards of judicial review. We expect that this case will serve as a veritable textbook for the conduct of future going private transactions involving Israeli targets and the adjudication of lawsuits challenging them.

Background

When the transaction commenced in October 2015, Nestle owned 64% of the outstanding shares of Osem, a TASE-listed company, and it proposed to acquire the public's 36% stake by way of a reverse triangular merger. Since this was an acquisition by a controlling shareholder, Osem's board of directors formed a committee of independent directors to evaluate and negotiate the proposed transaction.[2] The committee retained independent financial and legal experts to advise it throughout the transaction process and obtained a fairness opinion regarding the agreed price from another independent financial expert. Following the committee's recommendation, the merger was approved by Osem's audit committee and board of directors and by a majority of its non-interested shareholders. The merger was consummated in April 2016, several weeks after one of the public shareholders filed a motion for class action certification relating to the transaction.

Plaintiff's Allegations

The plaintiff raised a plethora of allegations against the transaction process that allegedly led to an inadequate price being paid to the public shareholders, including the following:

- that the shareholder approval was based on inadequate information, *viz.*, the shareholders were not informed about alleged flaws in the committee's work process, an alleged problem in the fee structure of the committee's financial advisor and certain information about the fairness opinion attached to the transaction report;

[1] Sharon Atsmon v. Osem Investments Ltd., Nestle S.A., Odyssey M.S. Ltd., and various officers and directors of Osem (TA D.Ct. August 3, 2020).

[2] Authorizing an independent committee to negotiate a controlling shareholder transaction is not required by law, but following the 2011 Machteshim Agan judgment in the Tel Aviv District Court (Economic Division), it has the become the norm in going private transactions in Israel. This follows the practice in the United States, stemming from the 1983 case of Weinberger v. UOP, Inc. (457 A.2d 701) in the Delaware Supreme Court.

- that minutes of committee meetings were doctored in retrospect;
- that the committee's process was circumvented and compromised by preliminary contacts between the parties in which information was provided to Nestle, by Osem's preparing overly conservative projections for the purpose of the transaction and by testing-the-water meetings held with significant minority shareholders;
- that the committee's financial advisor's independence was undermined by relationships of its affiliates with affiliates of Nestle and Osem and by conditioning a large portion of its fee on the publication of its appraisal;
- that the committee received preliminary advice from a representative of Nestle;
- that the committee's agreement to structure the acquisition as a reverse triangular merger, as opposed to a tender offer, was illegitimate;
- that the committee did not interview a sufficient number of candidates for financial advisor;
- that the effectiveness of the committee process was undermined by a meeting solely between the financial advisors of both parties at which minutes were not recorded;
- that the transaction was timed by Nestle to take advantage of a low point in Osem's market price and was part of a long-term strategy which included the purchase of a founder's shares two years earlier at a higher price;
- that the committee compromised its negotiating position by revealing assumptions underlying its company appraisal to Nestle;
- that the committee relied on a deficient company appraisal and failed to amply scrutinize its material elements;
- that the committee failed to amply scrutinize the fairness opinion of its second financial advisor; and
- that the committee did not perform a market check for alternative acquirers.

Standards of Judicial Review

The Court held that if a controlling shareholder transaction is approved by the audit committee, the board of directors and a majority of the non-interested shareholders, as required by the Israeli Companies Law, following full disclosure regarding the transaction,[3] then the burden of proof falls on the plaintiff to demonstrate that the transaction terms were unfair. At the same time, the Court reasoned that since the Companies Law also requires that a transaction be beneficial to the company and since the foregoing approval process alone does not guarantee the most favorable terms achievable under the circumstances, there is a need for the Court to assess the transaction process itself to ensure that it

[3] In October 2020, in the wake of the Osem decision, the Israel Securities Authority published a position statement outlining the disclosure requirements that apply to going private transactions of reporting companies under the Israeli Securities Law.

was truly negotiated on an arm's-length basis with the aim to maximize the price paid to the minority shareholders.

The Court ruled that in order to determine the judicial standard of review that should be applied to a going private transaction, it should first examine whether the terms of the transaction were negotiated by an independent committee. If the answer is yes, the judicial standard applied will depend on the question of whether or not the committee's work process was properly conducted.

In other words, when examining going private transactions, the Court distinguishes between three different situations:

- The terms of the transaction were not negotiated by an independent committee;
- The terms of the transaction were negotiated by an independent committee, in a process free of meaningful flaws; or
- The terms of the transaction were negotiated by an independent committee, in a process beset by meaningful flaws.

If the terms of the transaction were not negotiated by an independent committee, the judicial standard of review is the ***entire fairness standard***. In such a case, the burden of proof would shift to the controlling shareholder to demonstrate both that the transaction process was proper ("fair dealing") and that the transaction terms were fair to the minority shareholders ("fair price"). A fair price means a price that falls within a range of fairness, not necessarily the highest possible price, because even in transactions between unrelated parties there is give-and-take and compromise on the terms.

If the terms of the transaction were negotiated by an independent committee in a process free of meaningful flaws, the judicial standard of review is the ***business judgment rule***. In such a case, the Court would show deference to the judgment of the committee and not second guess its conclusion regarding the fairness of the price.[4] Although the business judgment rule typically is not applied to transactions that involve conflicts of interest, a properly empowered and functioning independent committee that conducts the negotiations on an arm's-length basis on behalf of the controlled corporation effectively transforms a transaction with a controlling shareholder into one between unaffiliated parties. As this case demonstrates, however, even a well-intentioned independent committee with highly-qualified independent advisors may not succeed in meeting the Court's high expectations for what constitutes a flawless transaction process.

If the terms of the transaction were negotiated by an independent committee, but meaningful flaws are identified in the transaction process, the judicial standard of review is the ***enhanced scrutiny standard***, an intermediate standard falling between the poles of the two foregoing standards. In such a case, the plaintiff will have the burden of proof to demonstrate that the transaction price was unfair, *i.e.*, that it

[4] This follows the approach of the Delaware courts established in In re MFW Shareholders Litigation (Del. Ch., 2013) and Kahn v. M&F Worldwide Corp. (Del. S.Ct., 2014). As opposed to the Israeli Companies Law, however, the Delaware General Corporation Law does not require approval of a majority of the minority shareholders, and the Delaware courts condition the application of the business judgment rule on the company's advance undertaking to obtain such approval.

was beneath the range of reasonable prices, and the degree of scrutiny of the plaintiff's claims could differ from case to case, depending on the seriousness of the flaws in the committee process.

After considering each of the allegations, the responses of Nestle and Osem, the evidentiary documents, expert opinions and the testimonies and cross-examination of the relevant individuals, the Court rejected most of the allegations. Some of the claims were held to be unfounded based on the facts, some were held to be factually accurate but not constitutive of a flaw in the process and some were held to be an insubstantial flaw that did not undermine the committee's efficacy. However, since the Court also found a few meaningful flaws in the committee's process, despite a thorough effort aimed at maximizing the transaction price, the Court decided that applying the business judgment rule would not be appropriate and proceeded to evaluate the fairness of the price by applying the enhanced scrutiny standard to the plaintiff's claims.

Evaluation of Price

The Court evaluated the merger price in the same manner established by the Supreme Court of Israel in the context of appraisal rights in connection with a full tender offer, *i.e.*, the current value of the company based on a discounted cashflow analysis, without taking into account the potential synergies that the controlling shareholder may be able to implement following the acquisition of 100% ownership.[5] In addition, the Court ruled that the value of the shares should not be discounted for external factors, such as their having a low trading volume or being a minority stake.

The Court considered and rejected all of the alleged flaws raised by the plaintiff against the company appraisal utilized by the committee. In addition, the Court agreed to give weight to the facts that the merger price was supported by 75% of the shares held by institutional investors, by Osem's founding families and by the fairness opinion of the second independent financial advisor retained by the committee. The Court concluded that the plaintiff did not meet the burden of proof (based on the enhanced scrutiny standard) that the merger price was below the range of fairness. Accordingly, the case was dismissed. The plaintiff's appeal to the Supreme Court is currently pending.

Practical Guidelines

The Court's methodical approach in describing the role of the independent committee and assessing each of the plaintiff's claims serves as a road map for the proper handling of a going private transaction. The target company and its minority shareholders should be represented by a committee that conducts the negotiations with the controlling shareholder on an arm's-length basis, with the goal of maximizing the price paid to the minority shareholders. The committee members should be independent of the controlling shareholder and should have the authority to accept or reject the offer, to negotiate its terms, to explore alternative transactions (to the extent relevant) and to retain its own advisors. The committee should engage financial and legal advisors who are independent of the controlling shareholder and should scrutinize the material elements of the company appraisal utilized by its financial advisor, who itself should scrutinize the projections provided by the company. The committee should obtain all

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[5] *See* Dan Atsmon v. Bank Hapoalim B.M. (S.Ct. December 28, 2009) and Kitel International Holdings and Development Ltd. v. Shaul Maman (S.Ct. August 28, 2012).

information it needs to evaluate the transaction and the value of the company's shares and should prevent disclosure of information about the committee's deliberations and strategy.

The Court emphasized that it would be insufficient to focus only on the establishment of the committee and its mandate. Rather, the Court will review the actual conduct of the committee throughout the transaction process to ensure that it acted reasonably in order to achieve the best terms possible under the circumstances for the benefit of the minority shareholders.

In order to evaluate the work of the committee, the Court will carefully review the minutes of its meetings. Accordingly, the minutes should be sufficiently detailed to enable the Court to evaluate the information reviewed by the committee and the nature and thoroughness of the deliberations. If actions taken, questions asked or decisions made by the committee are not reflected in the minutes, it may be difficult to convince the Court that they occurred.[6] In addition, the Court will compare (and will enable the plaintiff to compare) the final version of the minutes to drafts thereof, and any substantive discrepancies between the versions will be scrutinized. If meetings relating to the transaction are held but minutes are not recorded, even if they were not committee meetings per se (*e.g.*, meetings between the respective financial advisors of the parties or meetings with significant minority shareholders), the meetings may be treated with suspicion.

The Court's expressed goal in carefully dissecting a going private transaction is to protect the interests of the minority shareholders by ensuring that a committee (and its advisors) independent of the controlling shareholder effectively negotiates on their behalf with the aim to maximize the price paid for their shares. The Court reasoned that the controlling shareholder also stands to benefit from a proper transaction process because it provides certainty that the agreed price will not be increased by the Court following the closing, when it would be too late to withdraw from the transaction.

The Court acknowledged that applying an overly exacting standard could discourage controlling shareholders from undertaking going private transactions. Still, as described above, the Court set a very high bar for an independent committee to earn the protection of the business judgment rule. At the same time, by applying a strict version of the enhanced scrutiny standard to the plaintiff's attempt to prove the unfairness of the price, the Court leaves independent committees with the confidence that an earnest and thorough transaction process will be respected.

Our firm represented Nestle in the merger transaction and represented Nestle and Osem in the litigation of this case.

[6] *See also* the opinion of Judge Ronen in the 2015 case of Neuman v. Financitech in the District Court of Tel Aviv (Economic Division), which emphasizes the importance of detailed minutes for establishing the protection of the business judgment rule.

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