

PROBLEM
PARENT-PUBLIC SUBSIDIARY STOCK MERGER

Mayflower Hotel Corporation ("Mayflower") is a Delaware corporation. Its sole business is the ownership and operation of the Mayflower Hotel. Its outstanding shares of capital stock consist of 390,000 shares of common stock, \$1 par value per share. 330,000 shares are owned by Hilton Hotels Corporation ("Hilton"), a Delaware corporation. The remaining shares are publicly held and are thinly traded on the so-called over-the-counter market.

Hilton and its subsidiary corporations are in the business of owning, leasing, operating and managing hotel properties across the United States. Hilton has outstanding 1,600,000 shares of common stock, \$5 par value per share, which are actively traded on the New York Stock Exchange. Six years ago, Hilton acquired a majority of the outstanding shares of Mayflower. Hilton now proposes to complete its acquisition by merging Mayflower into Hilton in a stock merger.

The Board of Directors of Mayflower consists of nine persons, six of whom are directors or officers of Hilton, or have substantial business relationships with Hilton. The remaining three directors, Fleming, Folger and Baxter, are officers of Mayflower, and have no other business or financial relationship with Hilton. When Hilton proposed the merger, the Mayflower Board appointed Fleming, Folger and Baxter as a committee (the "Committee") to determine a fair basis of exchange of Mayflower stock for Hilton stock.

The Committee's employed (i) a law-firm, Lipton, Tea, to advise them as to their responsibilities, and (ii) an investment banking firm, Bulls & Bears, to advise them as to the relative values of shares of Mayflower and Hilton common stock. Neither Lipton, Tea nor Bulls & Bears has any other financial or business relationship with Hilton.

J.G. Haslam, Vice President of Bulls & Bears, presented to the Committee a forty page study comparing "the operating trends of each of the corporations and of the investment characteristics of the two stock issues." The key financial data found by Haslam is set forth in Appendix A attached.

Haslam concluded that "purely upon a statistical basis" the value of a Mayflower share was no more than three-quarters (0.75) the value of a Hilton share. Nevertheless, based on "the advantages incident to complete ownership," Haslam was of the opinion that a share-for-share exchange (a 1-to-1 exchange ratio) would be "fair and reasonable to all concerned."

After receiving Haslam's study, the Committee recommended an exchange ratio of 1 Hilton share for each Mayflower share. Hilton agreed to the 1-to-1 exchange ratio. The Board of Directors of Mayflower unanimously approved the merger, and

submitted it to a vote of the Mayflower shareholders. At the shareholders meeting, Hilton voted all of its 330,000 shares in favor of the merger. Of the remaining 60,000 shares, 45,000 shares were not voted, 10,000 voted in favor of the merger, and 5,000 voted against. With over 87% of the shares voting in favor of the merger, it was approved by the shareholders.

I. M. Gadfly, a minority shareholder of Mayflower, objects to the merger on the grounds that a 1-to-1 exchange ratio undervalues the shares of Mayflower. Gadfly sued Hilton and all Mayflower's directors in the Delaware Court of Chancery, claiming that each violated his or its fiduciary duties to Gadfly.

Gadfly's primary objection to Haslam's study is that it did not determine the "net asset value" of Mayflower. Gadfly has submitted a report of his own financial expert that the Mayflower stock has a net asset value of about \$27 a share. This value was determined by substituting for the accounting value of the Mayflower Hotel its value as a going concern, determined by capitalizing the hotel's earnings. Gadfly argues that the shares of Hilton to be received in the merger should be valued at their current market value of \$14.75. On this basis, Gadfly argues that the proper exchange ratio is \$27 to \$14.75, or 1.83 Hilton shares for each Mayflower share. A summary of the report of Gadfly's expert is attached as Appendix B.

Haslam has submitted an additional report that determines the value of Hilton's hotel properties on a going concern basis. Haslam uses rates of capitalization of earnings derived from the Gadfly expert's appraisal of the Mayflower Hotel. Haslam then applies those rates to the earnings of the Hilton properties. This results in net asset values of Hilton stock of between \$30 and \$40 per share. On the basis of relative net asset values, Haslam concluded that the value of a each Mayflower share was between 0.68 and 0.90 Hilton shares. A summary of Haslam's additional report is attached as Appendix C.

Assuming that Gadfly had standing to bring his action, please advise Hilton and the Mayflower directors as to the following, giving reasons to support your answers:

- (a) What standard of review will the court to apply in reviewing the merger?
- (b) Assuming that the only evidence that will be admitted at trial is the two Haslam reports, and the report of the Gadfly expert, discussed above, what are the strengths and weaknesses of Hilton's position, and what is the likelihood that Gadfly will prevail in the trial court?

Note: The facts for this problem are drawn from *Sterling v. Mayflower Hotel Corp.*, 33 Del.Ch. 20, 89 A.2d 862 (Del Ch.), *aff'd*, 33 Del.Ch. 293, 93 A.2d 107 (Del. 1952).

**Comparative Financial Data
Mayflower Hotel Corporation and Hilton Hotels Corporation**

**Appendix A
Haslam Report**

	Mayflower	Hilton	Mayflower to Hilton Ratio
Average Earnings Per Share			
10-year Average:			
Before income taxes & extraordinary items	2.17	4.31	.50
After income taxes & extraordinary items	1.17	2.79	.42
Current year			
Before income taxes & extraordinary items	3.14	4.22	.74
After income taxes & extraordinary items	1.15	2.37	.49
Dividends Per Share			
10-year Average	.34	1.07	.32
Current year	.40	1.20	.33
Book Value Per Share			
Per books	14.38	18.26	.79
Adjusted	13.98	18.42	.76
Market Value Per Share			
Average, Year 9	11.25	12.88	.87
Average, Year 10 (last year)	15.56	15.46	1.01
Approximate current price [at date of study]	16.25	14.75	1.10

**Appendix B
Report of Gadfly's Expert**

Net Asset Value per Share (NAV)	27.00	---	---
Current Market Value per Share (Market)	---	14.75	---
NAV-to-Market Ratio			1.83

**Appendix C
Haslam Supplemental Report**

Net Asset Value per Share	27.00	30.00	0.90
	27.00	40.00	0.68